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Notes

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Eligibility for Legal Aid: Whom to Help When Unable to Help All

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I. INTRODUCTION

In the face of needs and claims which far outstrip the funds and personnel required to meet them, social agencies always have had to decide how to distribute their inadequate resources in ways which satisfy their sense, if not their criteria, of distributive justice. Organized legal aid programs have not been spared these difficult decisions and, as other agencies, have sought to devise more or less formal methods for determining the eligibility of candidates for aid.[1] The least formal methods have been based upon unstated and highly discretionary criteria—open to caprice, arbitrariness, and personal as well as class bias. Even the more formal, stated, and sometimes written criteria have achieved only modest clarity and fairness.

Irregularly, and while learning how difficult it is to be clear and consistently fair in these matters, the providers of free or reduced-cost legal aid have tried to disburse their resources effectively. In doing so, however, they inevitably face some traditional and still puzzling moral dilemmas which entail both loose-jointed but prevalent cultural convictions and those more disciplined and reflective judgments concerning the standards of distributive fairness. Not unlike other areas involving the disbursement of resources, legal aid agencies have had to take stands, however formal, on the comparative weight to be assigned to the needs, merits, and social contributions of potential recipients. They have had to ask whether

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[1]This Article, it should be noted, is concerned with *microallocation* problems. It does not consider the *macroallocation* problem of determining how much of society's resources should be allocated to legal aid vis-a-vis, *e.g.*, education, housing, or medical care. Rather, the inquiry is about fairness in the allocation of those resources which have been assigned to the area of legal aid.

"first-come, first-served" is the fairest principle or whether certain persons or cases are "more worthy" than others. In settling these and related questions, they have also had to consider the amount of attention that should be paid to the potential "social contribution"of the petitioner, or, for that matter, to the convictions and interests of the public and professional colleagues.

With a full measure of sympathy, born of analogous experiences with household and university resources, and humbled by professional efforts to understand notions and principles of distributive justice, I propose an exploration of these dilemmas from the viewpoint of social ethics. Intending to contribute to the quest for clarity and equity in the expression and application of eligibility criteria, the following considerations are offered to stimulate public discussion of which human values and principles of justice ought to be overriding and normative in matters of this sort. Acknowledging in advance that the pluralistic character of our society makes agreement in these matters most difficult, and that decisions about distributions tend to be made rather as compromises arising from the clash of competing interests, this Article, nevertheless, hopes to advance fairness in policy making which, while respecting plural rights and freedoms, requires also that the decisions and actions made in that setting become increasingly more principled and rationally justifiable. Regrettably, the question of how to distribute fairly often is reduced to questions which ask *who* is to decide how to distribute. Valid though they are, these questions lead inevitably to debates about authority and power—all of which may produce more heat than light and which cannot be fully resolved without principles for guiding distribution, irrespective of who the distributors are. Even the most vigilant efforts to keep principles uppermost in one's considerations may, however, become derailed in ways which attend to irrelevant or invidious differences in the people to be served.

Wishing to keep considerable distance between the approach proffered in this Article and those which seek to address these matters authoritatively with exact and absolute determinations of right and wrong, the problems will be considered as follows. After recounting the kinds of eligibility criteria commonly employed in the distribution of legal aid, an inquiry will be made about which criteria best respect the most widely accepted requirements of distributive fairness in the comparative treatment of individuals. In order to answer this question, it will be necessary to test the justifiability of the moral claims and warrants entailed in these criteria, and, in particular, the stands they imply concerning the priority of the conventional ways of comparing individuals—in terms of need, desert (or worth), and social contribution. These inquiries

shall lead to still further, and perhaps more fundamental, judgments which are involved less obviously, but nonetheless importantly, in the articulation and application of eligibility criteria. Reference is made here to judgments about the nature and goals of American society and to other critical assumptions in eligibility standards as well as to the legal, economic, and ethical theories mustered in their support. Thus, some conclusions will be reached with respect to the ways in which these standards can mirror and serve to advance dominant cultural and professional convictions. Thus too, the manner by which loyalities to and preferences for certain dominant cultural and professional values impede progress toward more principled and rationally justifiable decisions in the recurring dilemma of whom to help when not all can be helped will be considered.

II. Discretion, Judge Bridlegoose, and Due Process

A. Private and Unorganized Legal Aid

It is not always easy to determine how the private and unorganized bar decides either to take or to reject a case if a client is in need of legal assistance, but unable to pay for the services desired. The all too few studies of this matter testify to a lack of formal and written criteria for the provision of personal and private legal aid.[2] They also demonstrate what seems inevitable—an irregular and inconsistent use of ad hoc criteria, with a maximum of discretionary power in the hands of the provider.[3] Furthermore, as one such study revealed, the actions and attitudes of the private bar indicate that private attorneys often are simply unaware of the eligibility criteria used in organized and publicly-funded efforts such

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[2]*See* Carlin & Howard, *Legal Representation and Class Justice*, 12 U.C.L.A. L. Rev. 381 (1965); Lochner, *The No Fee and Low Fee Legal Practice of Private Attorneys*, 9 Law & Soc'y Rev. 431 (1975); Maddi & Merrill, The Private Practicing Bar and Legal Services for Low-Income People (1971) (available from American Bar Foundation, 1155 E. 60th Street, Chicago, Ill. 60637).

[3]*See* Lochner, *supra* note 2, at 462-65. In analyzing the results of the study, the author stated with respect to indigent or partially indigent clients who were referred to the attorney by intermediaries:

> Lawyers take NF/LF [no fee or low fee] clients in return, most typically, for hoped-for future legal business. They also take such clients to please a friend or crony or to satisfy feelings of obligation towards neighborhoods or ethnic communities. Intermediaries perform their tasks in exchange for the political or other support of NF/LF clients and expect to provide some rewards to the lawyer if the client is unlikely to be able or willing to do so. And, finally, though clients accept free legal services they pay for them in terms of the business they may bring in, or the favors they may do, for both lawyers and intermediaries. The rewards are not just economic, they are also social, political, fraternal and psychological.

Id. at 463.

as that of the Legal Services Organizations.[4] This study concluded that the private bar is inclined to individualize rather than organize solutions to the problem of inaccessible legal aid and that, while continuing to believe that everyone is entitled to equal protection and its prerequisite in equal access, the private bar does little to translate this belief systematically into any particular form of organized aid.[5]

This phenomenon is partially explained by the fact that these lawyers are not accountable either to public review or to boards of directors as found in organized but private agencies. Should one believe that lawyers are accountable, nonetheless, to some professional set of standards or held liable under the disciplinary rules of bar associations, one only needs to examine briefly the ethical considerations and disciplinary regulations of canon two of the Code of Professional Responsibility.[6] This canon promotes an ambiguous and nonenforceable ideal of benevolence and leaves the nature and standards of the alleged obligation to make legal services fully available so indeterminate and subject to individual interpretation as to be an ineffectual guide.[7] Furthermore, the content and style of the Code on this matter is an outgrowth of the American tradition of voluntary benevolence, *i.e.*, almsgiving[8]—a tradition appealed to and led about as far as it might be taken by Reginald Heber Smith, the primogenitor of the legal aid movement in this century.[9] Finally, as Eric Schnapper noted:

> One searches in vain for a lawyer disciplined for *failing to give free legal service to the indigent*, for failing to disclose legal precedent contrary to his clients' interests, for misrepresenting facts to judges, juries or opposing counsel, or for using political office or connections to attract clients, although the frequency of these occurrences is common knowledge.[10]

Thus, unaccountable to any effective and determinate set of standards and review, either from within or from without the profession, private lawyers are on their own in the determination of

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[4]Maddi & Merrill, *supra* note 2, at 21.

[5]*Id.* at 20.

[6]ABA CODE OF PROFESSIONAL RESPONSIBILITY, Canon 2, EC 2-16, EC 2-25 (1978 version) [hereinafter cited as ABA CODE]. The Code has no disciplinary rule which corresponds to the obligation to make legal services fully available.

[7]*See* Smurl, *In The Public Interest: The Precedents and Standards of a Lawyer's Public Responsibility*, 11 IND. L. REV. 797, 817-25 (1978).

[8]*Id.* at 801-11.

[9]*See generally* R. SMITH, JUSTICE AND THE POOR 145-49 (1924).

[10]TIME, Apr. 10, 1978, at 56, 59 (emphasis added).

moral puzzles for which conventional, familial, social, and religious training normally will have rendered them as ill prepared as has their professional preparation in law school. Since there are no professional or organized forms of testing their judgments in this matter, it seems inevitable that their standards will be prone to a certain degree of arbitrariness as well as personal and class biases. Even the most virtuous and benevolent of lawyers will experience some difficulty in forging a consistently clear and equitable set of standards by which he may help make legal services fully available. At the end of the spectrum, however, stand others little inclined to virtue and animated by less than benevolent goals. These lawyers may emulate the practice of Rabelais' Judge Bridlegoose who awarded his sentences and judgments "by the lot, chance, and throw of the dice."[11] Perhaps too, they disagree with what seems incontrovertible—namely, that the decision to have no policy is itself a policy decision, and, in this case, a policy of maximum discretion in determining who among the indigent will be given access to the enfranchising power of our legal system. Finally, whatever be the standards and supporting warrants of the private bar, it appears they perforce will remain private and cannot, therefore, be included in the kind of public moral discourse envisioned as a major goal in this present study.

B. Private but Organized Legal Aid

Turning to private *but organized* forms of legal aid, one finds a very different situation in which, for several different reasons, the criteria of eligibility have had to be more explicit and more susceptible to scrutiny either by boards of directors or by national associations. In 1967, Lee Silverstein reported and analyzed the results of a major study of legal aid organizations.[12] Although this study must be somewhat outdated, it is the most recent major study of such organizations and will provide at least a beginning for consideration of patterns and dilemmas in the formulation of eligibility standards. Silverstein surveyed 275 private but organized legal aid organizations and found that, contrary to the recommended standard of the National Legal Aid and Defender Association (NLADA), agencies should have explicit and published standards of eligibility,[13] fifteen

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[11]E. RABELAIS, GARANTUA AND PANTAGRUEL, *reprinted in* 24 GREAT BOOKS OF THE WESTERN WORLD 206 (1952).

[12]*See* Silverstein, *Eligibility for Free Legal Services in Civil Cases*, 44 J. URB. L. 549 (1967). The surveys, conducted in 1966 and 1967 and including virtually all active legal aid offices, were financed by the Office of Economic Opportunity and conducted by the American Bar Foundation in cooperation with the National Legal Aid and Defender Association. *Id.* at 549.

[13]Nat'l Legal Aid & Defender Ass'n, Standard 3 (adopted Nov. 19, 1965), *reprinted in* 24 LEGAL AID BRIEF CASE 61, 62 (1965). The standard provides in relevant

percent of the agencies questioned had no written rules on the matter.[14] Among these latter agencies, some appeared to have well-defined but unwritten policies. Others apparently had neither written nor clearly articulated policies[15] and, one should think, were consequently prey to pitfalls similar to those of the private bar—namely, arbitrariness and bias. Furthermore, despite the liberalizing tendencies attributed to the impact of the federal Legal Services Program[16] upon private agencies, Silverstein found that some of the private agencies surveyed had unreasonably restrictive rules of financial eligibility or unnecessarily narrow restrictions on the subject-matter of cases to be accepted by those agencies.[17]

Eligibility criteria serve, of course, as screening devices. They help agencies determine who will be helped when inevitably limited resources make it difficult, if not impossible, to help all. They are designed most commonly to "screen out" members of the military or members of other special groups for whom services are available elsewhere.[18] In addition, at least in privately-funded agencies, residency tests are employed to limit service primarily to those residing within the area from which the funding has been generated—such as United Fund campaign areas.[19] The primary focus of this discussion, however, will be on the financial and subject-matter tests because they directly involve a host of puzzles in comparative justice.

The test for financial eligibility is intended expressly to allocate limited resources to the more indigent and to determine need on the basis of ability to pay. Silverstein uncovered two types of eligibility tests: a gross and largely subjective interpretation of whether a client might be able to afford a private lawyer, and another more objective test employing quantifiable methods of determining one's ability to pay, by comparing, for example, income and necessary ex-

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part: "The agency should establish, publish, and follow standards and procedures for determining the eligibility of applicants taking into consideration all relevant factors such as income, assets, obligations, size and health of family, recent or imminent unemployment, and the nature of the problem to be handled." *Id.* The NLADA is the contemporary counterpart of the organization of legal aid societies begun and fostered by Reginald Heber Smith.

[14]Silverstein, *supra* note 12, at 549-50 n.3. Silverstein noted that the incidence of agencies lacking explicit policies was especially high in agencies staffed by volunteers. *Id.* at 549.

[15]*Id.* at 540-50 n.3.

[16]The Legal Services Program is discussed at notes 26-40 *infra* and accompanying text.

[17]Silverstein, *supra* note 12, at 549-50.

[18]*Id.* at 553.

[19]*Id.*

penditures.[20] Judging the latter more satisfactory than the former, Silverstein unearthed even in the more objective test dubious and inconsistent standards—quantifiable, but potentially unfair nonetheless. For example, nearly a third of the offices using the more objective test employed indices of poverty below generally accepted standards such as those of the Bureau of Labor Statistics, or they used formulae which had the effect of discriminating against families by beginning calculations with the financial obligations of one individual and then adding increments for one's spouse and other dependents.[21]

The subject-matter test entails potentially still more difficult puzzles in so far as it seeks to minimize the impact which free services might have upon the private bar and its economic market.[22] In seeking to harmonize several potentially competitive interests, subject-matter tests prohibit the agency from accepting certain kinds of cases, such as the "hands-off" policy Silverstein uncovered in some agencies' handling of divorce cases.[23] Subject-matter tests are not concerned with the needs or financial capabilities of potential clients; rather, they are a pragmatic device—arising perhaps from pragmatic perceptions of necessity—to limit services and allocate resources more efficiently. Questions about their fairness, however, inevitably must be raised, as must the questions which ask whether these tests create possibilities either for discriminatory judgments about certain classes of persons or for undue pressure from political, social, and professional interest groups.

C. Organized and Public Legal Aid[24]

Before considering more fully whether these criteria respect the requirements of distributive justice, this account of the contemporary uses of eligibility criteria in legal aid shall be completed by considering data drawn from the more public and more liberally conceived criteria of Legal Services Organizations (LSO). The most up-

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[20]*Id.* at 552. *See also* Gardiner & Young, *How Does Your Office Determine Eligibility?*, 17 LEGAL AID BRIEF CASE 72 (1958).

[21]Silverstein, *supra* note 12, at 567-68. The author concluded: "For single persons, nearly all the legal aid eligibility rules reported are at or above the poverty line . . . . For a family of four, however, the eligibility rules of a high proportion of legal aid offices are so stringent that they exclude many families who are considered poor . . . ." *Id.* at 567.

[22]*Id.* at 551, 583.

[23]*Id.* at 572.

[24]"Organized and public" here is restricted to civil cases, although part of the discussion applies as well to public defender and criminal systems of legal aid. One should also note that Silverstein earlier had studied and reported on legal aid for criminal cases. *See* L. SILVERSTEIN, DEFENSE OF THE POOR (1965).

to-date national picture of the criteria used by LSOs comes from Earl Johnson, Jr., the former national director of the earlier counterpart organization, the Legal Services Program (LSP) of the Office of Economic Opportunity (OEO). In 1974, Johnson recounted the formative years of the LSP and considered some of the difficulties encountered in elaborating and applying eligibility criteria.[25] Noting that the LSP, by statute and philosophy, was confined to the lowest income strata, Johnson accounted not only for the prominence of the financial test in OEO eligibility criteria, but also for some of the special problems encountered in articulating and applying this test.[26] These difficulties included, at one end, a perception by the private bar that the levels of eligibility were set too high and were thus a threat to private practice in some places.[27] At the other end—that of the client or consumer—Johnson recounted two cognate and more aggravating problems OEO experienced with eligibility tests. One was the discovery that 112 million people were either "near-poor" or of moderate means but, in either case, were unable to acquire needed legal services.[28] Too rich to pass the OEO financial test, they were also too poor to pass the "tests" of private practitioners. Johnson and others uncovered the other problem in a network of cognate social and economic disabilities afflicting the poor. In brief, they discovered that the poor often pay more for necessary goods and services, that a host of factors other than salaries affect their income,[29] and that eligibility rules concerning residency,[30] as well as the notorious substitute-parent rules,[31] have the effect of excluding the poor from a fair share of goods and services specifically designed to help alleviate their plight.

These problems anticipate considerations to be discussed later. They are noted here in support of the proposition made earlier—that eligibility rules commonly employ residency and group-membership tests and most commonly rely upon financial and subject-matter tests in determining whom to help. Whereas Johnson's comments of 1974 focused primarily on the financial test,

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[25]E. JOHNSON, JUSTICE AND REFORM (1974).

[26]*Id.* at 100, 236.

[27]*Id.* at 95-99.

[28]*Id.* at 236.

[29]*See* D. CAPLOVITZ, THE POOR PAY MORE (1963).

[30]*See* E. JOHNSON, *supra* note 25, at 203, 346 n.98.

[31]Typically, substitute-parent rules denied welfare assistance to children if their mother cohabited with a man even though he had no obligation under state law to provide support. The validity of such provisions has, however, been successfully challenged. *See* King v. Smith, 392 U.S. 309 (1967) (holding the Alabama substitute-parent rule invalid under 42 U.S.C. §§ 601-609 (1976) (which deals with the Aid to Families with Dependent Children Program). *See also* E. JOHNSON, *supra* note 25, at 203, 346 n.97.

a year later he concentrated upon the puzzles involved in subject-matter tests, or better still, the implications of the fact that subject-matter tests are not often expressed, but are invoked and applied implicitly in the way caseloads are handled.[32] Consider first the most obvious subject-matter test, embedded in the enabling legislation of the 1974 Legal Services Corporation Act,[33] which not only reshaped the administrative handling of LSPs, but also added some subject-matter limitations by proscribing the acceptance of desegregation[34] and abortion cases.[35] Johnson found the constitutionality of these limitations doubtful,[36] but one might also question, as will be done in the next section of this Article, whether they sufficiently respect the requirements of distributive justice.

In addition to these most obvious subject-matter tests, Johnson pointed out subtle ways in which allocation decisions become, in effect, subject-matter tests and also tend to reflect the economic, political, and professional pressures which can be brought to bear upon the provision of free legal services. First, there are implications in the decision not to decide. In the absence of a policy, the allocation of time and personnel to the scores of divorce cases referred from welfare departments had the effect of not permitting lawyers to challenge statutes which made the filing of a divorce a prerequisite to welfare.[37] Second, under the ABA Code of Professional Responsibility, lawyers are forbidden to accept employment with legal aid offices which do anything more than set *broad policies* and assure there will be no interference in the lawyer-client relationship.[38] Thus, operating under "ethical" constraints and following the principle of local decision-making and control implicit in the administrative framework, LSO offices labor under an ambiguity in the application of eligibility criteria.[39] Although the power to establish and to supervise the application of these guidelines rests officially in

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[32]Johnson, *Further Variations and the Prospect of Some Future Themes*, in TOWARD EQUAL JUSTICE: A COMPARATIVE STUDY OF LEGAL AID IN MODERN SOCIETIES 133, 220-32 (1975).

[33]Legal Services Corporation Act of 1974, Pub. L. No. 93-355, 88 Stat. 378 (codified at 42 U.S.C. § 2996 (1976)).

[34]42 U.S.C. § 2996f(b)(7) (1976).

[35]*Id.* § 2996f(b)(8).

[36]Johnson, *supra* note 32, at 223 n.174.

[37]*See* Silver, *Imminent Failure of Legal Services for the Poor: Why and How to Limit Caseload*, 46 J. URB. L. 217, 225 (1968). .

[38]ABA CODE, EC 5-24 (1978 version) provides in pertinent part: "Various types of legal aid offices are administered by boards . . . composed of lawyers and laymen. A lawyer should not accept employment from such an organization unless the board sets only broad policies and there is no interference in the relationship of the lawyer and the individual client . . . ."

[39]*See* E. JOHNSON, *supra* note 25, at 166-84.

the board of directors, the force of the Code and the traditional sense of a professional's autonomy to which it appeals have the effect of giving the staff director and attorneys considerable discretionary power.[40] LSO criteria, consequently, are more explicit or publicly accountable, but also continue to reflect dominant attitudes of the private bar which favor individualized and discretionary activity in the distribution of legal aid. One cannot avoid noticing the irony in the fact that the attempts to organize legal aid along the lines of due process continue to rely heavily upon individualized discretion and the dubious example of Judge Bridlegoose.

III. Treating Individuals Singly and Comparatively

Several different and potentially conflicting values are evident in the preceding account of the tests applied in the distribution of free legal services in civil cases. These criteria promote more than the moral values of equality. They also serve to uphold, in many cases, nonmoral professional values as evidenced by the ample discretionary power granted to the distributors of legal aid. Also, they are often designed in ways which seek to safeguard either economic and market values or prevalent social and political convictions in the community. Finally, because they are devices for distributing limited resources, eligibility criteria pay more than average attention to the nonmoral ideal of efficiency.

In *Equality and Efficiency: The Big Tradeoff*,[41] Arthur Okun drew attention to the ways in which moral and nonmoral values conflict in economic and policy decisions. Reviewing the effect this conflict has on similar procedures in the field of legal aid, Earl Johnson noted that the policies of Legal Services Organizations include certain oddities, traceable to unsuccessful attempts to reconcile the values of efficiency and equality—such as the odd consequence that the most efficient distributions sometimes supply the least service or at least entail undesirable restrictions in the range of services offered and, thus, fail to meet needs equitably.[42] As in so many other areas of public life, the pressing question in legal aid is which value ought to have priority—efficiency or equality. This manner of phrasing the question does not mean to suggest that the decision about priority is always a choice of "either-or"; rather, it appears to be more in the category of "both-and." Nor does it intend to suggest that once made, the priority decision and its formulation ought to become absolute, inflexible, and unexceptionable. Nonetheless, from

[40] *See* Johnson, *supra* note 32, at 223-24.

[41] A. Okun, Equality and Efficiency: The Big Tradeoff (1975).

[42] *See* Cappelletti & Johnson, *Toward Equal Justice Revisited: Two Responses to a Review*, 1977 Am. B. Foundation Research J. 943, 949-52.

a moral point of view, and assuming that a person has reasons for and a commitment to being moral, moral values ought always to override nonmoral values. Efficiency, as a nonmoral value, ought to be overridden in almost every conflict by moral values, such as fairness in the distribution of benefits and burdens. Since fairness is not the only moral value, in some cases efficiency and other nonmoral values may override considerations of fairness—as when, and for moral reasons or in pursuit of moral values other than justice, such as honesty and integrity, nonmoral values may be given priority over fairness. Nonetheless, in both the rule and the possible exceptions to it, one ought to have some general criteria by which to guide decision and action in these affairs. If considerations of fairness and equality are ascendant to all other considerations, then one must have some fairly explicit and soundly supported moral criteria of the sort traditionally associated with distributive justice.

Commenting on analogous dilemmas faced in the distribution of medical care, David Mechanic observed that the social effects of maldistributed health care have always been monstrous, and that the resources for these services always have been and likely will remain limited and relatively inadequate.[43] Faced with a seemingly inevitable rationing of resources, the appropriate moral questions, according to Mechanic, are how to make the rationing process more equitable, more explicit, and more decisively controlled by general guidelines.[44] Mechanic has suggested a procedure by which public agencies, including many legal aid offices, might achieve more morally justifiable criteria eligibility. Mechanic's requirement that they be more explicit and public satisfies several important social and ethical requirements. The more *public* eligibility criteria are, the less likely they will remain highly discretionary. Public scrutiny, by raising the questions "who is to decide" and "by what authority," will serve to make the criteria increasingly more *explicit* and also to encourage the agencies to declare more openly whatever moral convictions may be guiding, however unconsciously, policies of distribution. As public and explicit, they not only would invite criticism and reformulation; they would also promote the kind of open, free, and public discussion of moral values necessary for the well-being of a pluralistic society committed to uphold the most valued qualities of human life.

No amount of publicity and explicitness will satisfy still another requirement suggested by Mechanic, and one upon which the public envisioned above inevitably will insist—that eligibility criteria be

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[43]Mechanic, *Rationing Health Care: Public Policy and the Medical Marketplace*, HASTINGS CENTER REP., Feb. 1976, at 34-37.

[44]*Id.* at 36.

guided decisively by more general guidelines. Whatever Mechanic may have intended, I take this to include perforce some general and universal propositions about what is normatively human—to wit, moral criteria. Although they are not necessarily more general or universal than many nonmoral criteria such as cost-benefit ratios and other general canons of efficiency, moral criteria are general judgments of moral obligation; characteristically they are principles of beneficence and justice.[45] Moral criteria, therefore, not only meet Mechanic's requirement of generality; they also, because of their characteristic superiority over other comparably general criteria, ought to override and to be more decisive than other general but less normative human criteria.

We must now determine which moral criteria are most relevant to the allocation dilemmas addressed by eligibility rules. Principles of beneficence—as, for example, in the general principles requiring that one help others and avoid harming them—are general and pertinent enough, but insufficiently decisive in matters of allocation. Although the principles of beneficence guide actions which promote the good and avoid harm and give rise to other more specific and prima facie rules concerned typically with honesty, keeping promises, and respecting rights, they do not explain "how one is to distribute goods and evils;" they only advise one "to produce the one and prevent the other."[46] Athough the prima facie rules of beneficence are relevant to many of the person-to-person encounters entailed in the distribution of legal aid, they are insufficient for guiding the policy which precedes and structures those encounters. Although well-suited to guide decision, action, and policy in the treatment of individuals, these rules are especially ill-suited to guide these same matters when the issue is the *comparative treatment of individuals*. The difference between treating individuals fairly but *singly* and treating them fairly and *comparatively* is critical, since allocation problems involve much more than conventionally perceived one-to-one relationships between the lawyer and the client. For interpersonal exchanges and interactions, the principles of beneficence are eminently relevant and effective guides.[47] Nonetheless, when occurring in the context of agencies distributing limited resources, these professional interactions are shaped in advance by the decisions made by other persons and by the policies which embody the judgments of those other persons. These judgments, because they

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[45]*See* W. FRANKENA, ETHICS 43-52 (2d ed. 1973).

[46]*Id.* at 48.

[47]*See, e.g.*, ABA CODE, *supra* note 6, EC 5-24. *See also*, Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relationship*, 85 YALE L.J. 1060 (1976).

concern allocations and determinations of how to distribute among many what is sufficient only for a few, must inevitably entail considerations of the comparative treatment of individuals and, unless they are to be completely arbitrary, an equally inevitable appeal to some standard of comparative or distributive justice.

Eligibility rules settle certain matters in advance of the individual practitioner's dealings with a client. They provide the agency's answers to questions of which clients and what kinds of cases are to be taken by the agency. In short, eligibility criteria entail comparative judgments and appeals to those principles of justice which are called distributive. They cannot, therefore, be evaluated adequately by testing their conformity to principles of justice designed to guide exchanges between persons (commutative justice),[48] much less by testing how well they respect the principles of beneficence. Despite the proclivity of some prevalent American moral intuitions to convert eligibility discussions to considerations of only one-to-one relations of contractual fidelity or personal and professional integrity,[49] one must insist resolutely that eligibility criteria be addressed first, foremost, and recurrently by considerations of comparative or distributive justice.

Having resolved that comparative justice is the appropriate arena for the consideration of eligibility criteria, further determinations must be made with respect to the selection of appropriate and relevant rules of comparative justice. Some may argue for rules of randomness—lottery or "first-come, first-served" types of rules. Others may suggest that the only formal and most truly justifiable rule is a general one stating the kind of impartiality which equality requires—namely, that "similars be treated similarly." Both of these suggestions offer little more than procedures and set forth rules which require only fair play. If treating individuals comparatively and fairly requires only that one play fair procedurally, either of these two proposals would suffice, but would serve also to justify almost any duly established or legitimate rule of eligibility—irrespective of its moral justifiability. Comparative justice, however, requires that fairness in the comparative treatment of individuals depends critically and finally upon the material content assigned to the terms "similar" and "dissimilar." Purely formal rules of randomness and impartiality are insufficiently concrete and leave too much still to be determined. Granting that they may be rules of fairness, it is not entirely clear that they are fair rules—a matter which can be settled only if one declares which particular

[48]Commutative or exchange type justice is sometimes called either contractual or compensatory.

[49]*See* Fried, *supra* note 47. *See generally* Smurl, *supra* note 7, at 811-17.

similarities or dissimilarities are relevant and determinative. There are, after all, ways of assuring that one's friends, relatives, and colleagues come first in line or are more similar to what one has in mind but leaves unstated. Just as the purely discretionary systems of distributing legal aid, without the benefit of explicit criteria, open wide the door to perhaps unwelcome but nonetheless unavoidable arbitrariness and bias, the purely procedural and merely formal rules of randomness and impartiality leave more than ample room for the exercise of favoritism and other forms of bias. Furthermore, and as Judge Bridlegoose observed: "[O]ftentimes, in judicial proceedings, the formalities utterly destroy the materialities and substances of the causes and matters agitated . . . ."[50]

If comparative justice and its standards are to be more than a chimera and are to do more than disguise injustice, its principles must be more substantive, concrete, and material. They must declare specifically the ways in which the individuals to be served are, comparatively speaking, either similar or dissimilar. Furthermore, and as will be seen presently, the more material and substantive the principles of comparative justice, the more they require that relevant, operative, but sometimes unstated and unjustifiable comparisons of people be made explicit. For instance, if those seeking free legal aid are to be treated similarly, then one must determine in which ways these people or their cases are either alike or different. In making these determinations, it is not enough simply to declare that people are either most alike or most different in financial, social, or other terms. These declarations must themselves be justified by appeal to some more general standard such as one of the traditional norms which declare that people ought to be compared and treated comparatively on one of the following bases: needs, deserts, or social contributions.

Against this background, one might inquire which of these more general standards are employed in conventional eligibility tests, and additionally which are the fairest for this particular endeavor. As noted earlier, beyond initial screenings for residency and possible coverage by other group services, the most prevalent eligibility tests are those which consider financial and subject-matter questions.[51] Financial tests make needs a central and guiding standard and can be said to respect, therefore, one conventional and materially concrete criterion of comparative justice, stated axiomatically in the formula "to each according to his need" or in the counterpart maxim "from each according to his ability." While financial tests must be constantly scrutinzed to insure the accuracy and currency

[50]F. RABELAIS *supra* note 11, at 206.

[51]*See* notes 20-23, 26, 33-35 *supra* and accompanying text.

of the empirical data used to estimate degrees of financial ability to pay, they are readily justifiable from a moral point of view. Assuming empirical validity, financial criteria respect the formal principle of impartiality and, in addition, do so by embodying this principle in a materially substantive criterion. Financial eligibility tests are ways of determining need and assuring that people of similar need will be treated similarly. Furthermore, they imply respect for the moral belief that people are equal in worth and dignity.

Financial tests are not, however, without problems. As Lee Silverstein noted, if they employ formulae which discriminate against those who are similar in need but who are married with dependents, they may not sufficiently respect the principle of impartiality.[52] This problem arises if spouses and dependents are calculated only incrementally; *i.e.*, as mere increments of financial responsibility beyond those of the wage earner whose financial obligations are the only ones to be taken with full seriousness and weighted properly.[53] Such criteria provide, in effect, that the financial capacity of the married person is most similar to that of the single person, and that spouses and dependents diminish that capacity only incrementally. This approach has the effect of declaring a parity where there is none, or making the truly dissimilar appear to be alike. In this, as in other subtle ways, irrelevant differences between people can be introduced in financial tests and their seemingly innocuous income tables. If this occurs, these tests must be judged to be less than fully respectful of the requirements of comparative or distributive justice.

Subject-matter tests are even more problematic and are much more likely places in which to find irrelevant and sometimes invidious comparisons of candidates for legal aid. In fact, unlike financial tests, they are more likely to default in the fairness comparative justice requires and to do so in their initial and overt purposes, as opposed to the seemingly unintended but unfair consequences of overtly fair financial tests. The subject-matter tests which discriminate between civil and criminal cases cannot be criticized, since free assistance is available for both, albeit from different agencies. These tests seem to represent a morally justifiable effort to

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[52]*See* Silverstein, *supra* note 12, at 567-86. The author stated with respect to this method of determining eligibility:

> [M]any eligibility rules, although not intended to do so, discriminate against potential legal aid clients who are members of families as against single, unrelated individuals . . . . It is surely odd that family units should be disfavored *vis-a-vis* unattached individuals whose legal difficulties, whatever they may be, do not also affect spouses and children.

Id. at 568.

[53]*See id.* at 555-68.

divide efficiently what are fundamentally fair but necessarily distinct kinds of assistance. One should, however, take issue with tests which exclude certain socially controversial issues on the one hand, or, on the other hand, cases for which the private bar has staked proprietary claims in order to safeguard its economic markets. The latter measures would be highly questionable if designed only to preserve the private sector's monopoly on highly lucrative legal practice. Barring such aggrandizement, economic protectionism can sometimes be a morally justifiable way of assuring the maintenance of the economic base of the profession and in such a way that it motivates the existing bar or attracts new members. Both of these latter functions assure a stable foundation from which professionals may advance more securely toward the goal of making legal services fully available.

By way of contrast with these potentially justifiable forms of economic protectionism, the former subject-matter tests, which exclude controversial cases, are not so easily justified on moral grounds. These tests are based upon blatantly unfair and discriminatory judgments about people or are tantamount to using morally unjustifiable forms of coercion in order to achieve the social goals of the majority. Consider initially some more readily obvious examples of discriminatory bias—those which differentiate treatment on racial, ethnic, sexual, and religious grounds. One might agree readily that these factors ought to be irrelevant in determining a person's eligibility for legal aid and that, if an agency excluded cases dealing with violations of civil rights for racial or religious reasons, the agency's eligibility rules would be unfair and would fail to respect the rule of impartiality.

Consider further, however, some subject-matter tests, the moral justifiability of which one is less likely to demonstrate readily. The two most common tests in this category, which have been used rather widely, excluded or severely limited divorce and bankruptcy cases. Although Brownell in his 1951 study had identified a most restrictive policy with respect to the acceptance of divorce cases,[54] Silverstein found a more relaxed but still partially restrictive policy on divorce cases as late as 1966.[55] Of the 159 NLADA offices surveyed, 21 simply would not handle divorce cases.[56] Eighty offices had restrictive policies, such as: (1) Accepting only a limited number of cases, (2) accepting only cases recommended by social agencies, courts, and attorneys, (3) imposing a "social test" which sought to calculate anticipated benefits or harms to the family or the com-

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[54]E. BROWNELL, LEGAL AID IN THE UNITED STATES 72-74 (1951).

[55]Silverstein, *supra* note 12, at 572-81.

[56]*Id.* at 574, 580-81.

munity, (4) restricting cases to defendants and excluding plaintiffs, and (5) accepting both while maintaining different eligibility rules for each.[57] Only 58 offices had minimal or no restrictions.[58]

Silverstein's analysis of the findings in this study suggests that these restrictions stemmed from several causes including budget inadequacies and were more likely to be found in offices relying upon volunteer as opposed to salaried attorneys.[59] He also found, however, that eligibility rules reflected community attitudes toward certain people and thus toward the role legal aid might play in helping those people: "Some attorneys candidly assert that a divorce is a luxury, thereby implying that none of the poor, or only the most 'deserving' ones, should be entitled to get a divorce through legal aid."[60] Such an attitude, and the eligibility rules which reflect and honor it, is aristocratic from at least one point of view. From another point of view, it smacks of patronizing welfare paternalism. From still another point of view—that of social ethics—it entails an appeal to one particular and dubiously relevant embodiment of the rule of impartiality; namely, the one expressed in the axiom "to each according to his merits or deserts." Called the meritarian standard of distributive justice and resting upon a judgment that people are to be likened in terms of what they merit or deserve,[61] it is a helpful and relevant criterion for determining prizes, some aspects of wages, and other matters where merit is an unquestionably fair consideration. It is not entirely clear, however, that such considerations are fair without question or altogether appropriate in the determination of eligibility for free legal services.

In fact, a most persuasive argument can be presented that meritarian tests are not normally applicable in the distribution of these services. As in the above assertions of some lawyers, they frequently entail aristocratic attitudes and patterns of patronizing welfare paternalism. More importantly, however, they fail to respect sufficiently the requirements of the moral belief at the root of the rule of impartiality—that equal regard is owed to every human precisely because he is human. Furthermore, and since they perhaps imply judgments that the indigent are needy because they are insufficiently industrious or that they do not need the "luxuries"[62] other

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[57]*Id.* at 574-79, 581.

[58]*Id.* at 579-81.

[59]*Id.* at 581.

[60]*Id.* at 574.

[61]*See* W. FRANKENA, *supra* note 45, at 49.

[62]In addition to its "no divorce" policy, the St. Louis office in the Silverstein study expressly categorized television sets and automobiles as being "luxury" items and, consequently, placed certain restrictions on accepting cases involving these items. Silverstein, *supra* note 12, at 583.

people find necessary, eligibility rules which exclude or restrict the acceptance of divorce cases tend to err in several other respects. From a moral point of view, they err by trying to fashion a criterion of distributive justice from what many believe to be the virtues of married life; namely, fidelity and permanency. Assuming that these virtues are relevant considerations in criteria of distributive justice, they could be justified only if there were a prior and equal distribution of the conditions for achieving these virtues.[63] There is, however, little reason to believe that such equality of opportunity has existed for the indigent who, by definition, are disadvantaged. Thus, an aristocratic appeal to a meritarian standard of comparative justice in these cases violates the moral requirements of equal regard and comparatively fair treatment and is tantamount to socially compulsive patterns called "coercion to virtue" which will be considered in the next section.

Another subject-matter test with similarily important moral implications is one which restricts agencies' acceptance of cases involving bankruptcy. These tests respond in part to pressures from the interests of local business and commerce—those with a stake in getting as much as possible from debtors and with more than average power to affect the funding sources of organized legal aid which often depends upon the collections made through United Funds.[64] Through these and other effective measures, social pressure and community norms can exert considerable influence on legal services.[65] These are not only questionable social and political tactics; they also imply some morally unjustifiable allocation policies.

Policies which exclude or restrict bankruptcy cases entail a judgment that people are to be compared and treated in terms of their social contributions—here interpreted as economic accountability. While such a criterion makes sense in the distribution of some goods and services and has been employed, though questionably, in the allocation of other scarce resources,[66] it does not make sense in every context and can entail, in some settings at least, quite irrelevant and very unfair comparisons.

The indigent may not have had an equal opportunity to make the necessary social contribution. They are "coerced" to pay by restrictions on their access to bankruptcy proceedings. By implica-

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[63]*See* W. FRANKENA, *supra* note 45, at 50.

[64]H. STUMPF, COMMUNITY POLITICS AND LEGAL SERVICES 130, 149 n.45 (1975) (citing Carlin & Howard, *Legal Representation and Class Justice*, 12 U.C.L.A. L. REV. 381, 415 (1965)).

[65]*See generally* H. STUMPF, *supra* note 64.

[66]*See, e.g.*, Note, *Scarce Medical Resources*, 69 COLUM. L. REV. 620, 658 (1969) (discussing the methods of the selection committee of the Seattle Artifical Kidney Center).

tion, they are being compared *not* to those who, having sufficient funds to pay for the proceedings, declare bankruptcy and from whom creditors are not likely to receive any more of the anticipated "social contribution" than they would from the indigent. Rather, they are being compared to those who are unable to pay for and thus to claim bankruptcy; those who must struggle to contribute whatever they can and from whom creditors may seek to squeeze at least some social contribution. In other words, the poor can be coerced into being fiscally accountable, and thus will be constrained to become poorer still, while those more financially able can have prior debts canceled and will be given an opportunity to begin again with a clean slate. The indigent are not less needy; they are simply more vulnerable to coercion. The wealthier do not necessarily make a greater social contribution; they are simply more able to escape being constrained to do so. When seen in this light, the comparison between these two groups of people—a comparison entailed or at least possible in bankruptcy restrictions—is more than irrelevant. It also entails an unfair and unwarranted suggestion that the indigent, who are less able to make the contribution expected but can be pressured into doing so, are truly comparable to their opposites. Thus, eligibility rules which honor and perpetuate this social ruse fail to respect sufficiently the requirements of equal regard and equality of treatment which form the substantive basis of the formal principle of impartiality—the requirement that "similars be treated similarly."

People needing free legal assistance are most similar in that they are indigent, not in their deserts (as implied in the divorce rules), and not in their social contributions (as implied in the bankruptcy rules). If comparative treatment be based upon need, then the financial test respects best the requirements of distributive or comparative justice. Limitations in the resources available to meet those needs require on occasion, however, that additional screening devices be adopted. These tests should conform as well as possible to the general moral criteria for fairness in distributions, but divorce and bankruptcy restrictions fall short of the conformity required. Furthermore, all subject-matter tests risk giving priority to nonmoral considerations—such as social, political, economic, and professional concerns. In this regard, they overturn the rule that moral considerations are overriding and ought to have priority in such conficts. Despite this reversal of the proper ordering of values, subject-matter tests are procedurally fair and appear to be morally plausible. Hence, in the following and concluding section of this Article, we shall consider some reasons why so few Americans become morally outraged about distributions which, while playing according to the rules, are nonetheless substantially unfair.

IV. Assessing the Nature and Power of Prevalent Cultural Convictions and Social Institutions

A. Introduction

The preceding sections have sought to demonstrate that, if eligibility decisions are to be more than merely arbitrary or discretionary and are to be relatively fair, they ought to be measured against and guided by the criteria of comparative or distributive justice. They also have sought to suggest that, of the several alternative standards, those which are equalitarian are more relevant and morally justifiable in the determination of eligibility for free legal service—than, standards of merit or desert and of social contribution. Also, this Article has noted that these eligibility decisions and the judgments about which criteria should guide them depend upon assumptions about the nature and value of people and the institutional arrangements of interpersonal social life.

Throughout, I have tried to scrutinize in the light of moral considerations matters which, because of the force of prevalent convictions and social institutions, are not often examined in this fashion. Reference is made here to the credibility some mistaken or at least morally questionable judgments acquire because they mirror or promote prevalent cultural convictions and existing institutional arrangements. Enjoying a presumption of validity which owes more to their prevalence than to their demonstrability, these judgments often override the more general considerations which moral questions try to raise. Although we can assume that lawyers generally have reasons for being moral, we must acknowledge that they also have professional commitments and practiced ways of plying their trade which can serve to override considerations of whether a particular policy, practice, or allied conviction is morally justifiable. Furthermore, for some attorneys at least, lawyers' ethics or ethics in the practice of law is a matter to be worked out rather exclusively in the terms and under the conditions of the prevalent convictions and procedures of the profession; in other words, without attending sufficiently to the more general obligations they may have as humans or individuals apart from their profession. Finally, because of the myriad ways in which law penetrates many other aspects of life, the social, political, and economic convictions of American culture and its dominant institutions provide sets of allied and equally forceful beliefs which also can override moral reasons.

Thus, what has been considered up to this point in terms of moral justifiability, must now be considered from the vantage point of professional, cultural, and theoretical convictions which either obscure moral questions or give moral force and prima facie plausibility to eligibility policies and decisions which are morally

dubious. While not intending to invest some dubious judgments with still further plausibility by attending to them too seriously, I hasten to note that the purpose here is to map out sets of convictions which stand in need of further critical testing before they can be used to argue for a particular position or policy.

Preferring to attribute these mistaken judgments to inattention or insufficient reflection rather than to malice or mischief, I shall propose some ways in which they may be reconsidered. In this effort, I join others who call for more extensive and more critical considerations of the same judgments,[67] but in such a way that attention is focused on the ways in which they foster a public and professional sense of justice which is only ostensibly, but not always demonstrably, fair. Furthermore, because of their prevalence and the persuasive power they have accumulated, one cannot be overly optimistic about our capacities for making consistently fair judgments or policies in the matter of eligibility for free legal services. While acknowledging that questionable senses and criteria of justice are not easily revised, much less readily eradicable, truer and fairer judgments may be gained if mistakes are detected and not repeated. Mistakes are one thing. Their replication and institutionalization are quite another. They are a particularly powerful social force for aggravating harms and unfair treatments if they derive their plausibility from uncritically or insufficiently examined moral beliefs, some of which are more prejudicial than reasonable.

Some of the more questionable judgments highlighted previously were those which attributed greater value to autonomy and discretion than to public accountability, those which ranked efficiency and procedural fairness higher than equality and substantive justice, others which erred by requiring virtue as a prerequisite for access to the administrative processes of legal justice, and those finally which failed to acknowlege the different requirements in treating individuals singly and in treating them comparatively. The following discussion will attend to three distinct but interrelated sets of considerations which give credibility and moral force to judgments which, while hardly justifiable in general moral terms, enjoy, nonetheless, the force of morality. These judgments and their corresponding credibility are properly termed de facto convictions. This terminology does not, however, suggest that all de facto convictions are by that very fact wrong. Rather, the purpose is to emphasize that they are just de facto and to challenge the assumption that they can be treated as if they were de jure simply because they are

[67] *See, e.g.*, Gorovitz & Miller, *Professional Responsibility in the Law* (1977) (reporting the recommendations of the summer 1977 Institute on Law and Ethics held by the Council for Philosophical Studies).

prevalent. Common sense can be erroneous as well as correct, and because the institutionalization of its errors can make for powerful social blind spots,[68] the license authorizing these convictions will be temporarily revoked, thereby permitting inquiry about whether they are indeed as demonstrable as they are made to appear.

B. Considerations Which Tend to Support and Sustain Seemingly Arbitrary and Purely Discretionary Procedures in Matters of Elibigility

Behavior which at first glance appears to be merely arbitrary or purely and self-interestedly discretionary may, in fact, be a result of lawyers' observance of professional standards. Codes of professional responsibility, sometimes called "codes of ethics," are in fact and viewed by some as necessarily at odds with more general and commonly shared judgments of morality. Thus, when challenged with charges of what, from a general and public view of things, seems to be immoral, professionals may be inclined to respond that it may be necessary to be immoral in order to perform effectively the tasks for which lawyers' services are engaged. We must inquire more fully and ask whether lawyers and other professionals can and must be allowed actions which otherwise are considered morally impermissible. In pursuing this inquiry, we might ask further whether the practice of law contains elements which might evoke and sustain a judgment that lawyers can, indeed must, diverge from common moral standards.

One potential source of convictions which might serve to exempt the lawyer from otherwise universal moral standards stems from an inevitable but sometimes overweening concern with the values peculiar to and characteristic of the profession, especially with values associated with social roles and the actions deemed necessary in the fulfillment of those functions.[69] Thus preoccupied with the needs of the profession, the standards and codes of the professional may mirror only imperfectly more general and public values and

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[68]The power of these blind spots is evidenced in the tendency to commit the informal logical fallacy of *argumentum ad populum*, missing the point to be proved and appealing to the beliefs of the community as evidence. Logicians traditionally account for this penchant in discourse in terms of loyalties, passions, and prejudices. *See* 3 THE ENCYCLOPEDIA OF PHILOSOPHY 176-78 (P. Edwards ed. 1967). It is also evidenced in moral theories accounting for the relationship between prevalent cultural beliefs and formal moral principles. *See* J. RAWLS, A THEORY OF JUSTICE 20-22, 48-51 (1971). *See also* R. DWORKIN, TAKING RIGHTS SERIOUSLY 155, 164 (1977); Smurl, *supra* note 7, at 825-28.

[69]*See* MacRae, *Professions and Social Sciences as Sources of Public Values*, 58 SOUNDINGS 3, 13-14 (1977).

may tend to insulate the profession from criticism based on these latter values.

As noted earlier, this situation owes less to mischief or malice than to inattention to the implications of preoccupation with characteristic professional values. Hence, in order to account for the sources of morally dubious judgments as well as to draw greater attention to the repercussions of certain professional convictions, certain problematic judgments, which stem from training in and the skillful practice of conflictual and competitive advocacy in an adversarial system, should be considered. Principal among the premises of such a system are convictions which provide the possibility of arbitrary, prejudicial, and self-interested eligibility decisions. Reference is made in particular to the important premise which evokes and sustains a commitment to represent zealously the interests of a client over against those of the opposing side, and which requires as well the keeping of a client's confidences and is sustained by immunity from revealing "privileged communications"—all in the interest of enhancing a client's competitive advantage in litigation.

These commitments inevitably come into conflict with other professional, not to mention other human, commitments. Even within the terms of the Code of Professional Responsibility, there are conflicting obligations such as those which require an attorney to act as an officer of the court and, thus, to aid in the search for the truth while simultaneously guarding the interests of but one party in the dispute.[70] As an officer of the court, the attorney may be required to perform in ways inimical to the client's interest and, as one disciplinary rule dictates, the lawyer might be required to disclose, in the course of a trial, "[l]egal authority in the controlling jurisdiction known to him to be *directly adverse to the position of his client* and which is not disclosed by opposing counsel."[71] Practically speaking, however, and as every lawyer knows—and this is the point about preoccupation with adversarial techniques and its values—there are ways to circumvent such requirements. In fact, there are opportunities for finding these ways within the Code itself, and for justifying the overweening importance of zealous advocacy even if it is in conflict with more common and public values such as the truth sought in judicial proceedings. Finally, because of the force of the professional ethos created by the adversary system, a means to avoid the requirements meant to preserve the common good more than likely will be sought and found—largely because these requirements are hard for professionals to accept because of instincts or intuitions generated by and necessary for success in adversarial conflict.

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[70] *Compare, e.g.*, ABA CODE, *supra* note 6, DR 7-102, 7-106(B) *with id.*, DR 7-101.

[71] *Id.*, DR 7-106(B)(1) (emphasis added).

Central to the conflict of obligations just cited is the overriding importance attached to participant control of the adversarial process. Allied significantly to and sustained by a common law tradition of protecting individual rights over interference from or control by governments and social systems, this value finds itself allied as well to cognate, fortifying, and widely prevalent social, political, and economic values. It is linked not only to values inherent in the Constitution and the tenets of liberalism, but also with freedom of speech in the market place of ideas which Justice Holmes extolled as the competitive and, therefore, the best test of truth.[72] In the very metaphor invoked by Holmes, one can observe another source of cognate and justifying convictions to support participant control over the process—namely, in the analogies implicitly drawn between the competitive relationship of litigants and the relationships between parties in free and competitive economic enterprises.[73]

It is relatively easy to see how the withholding of information and perhaps even the distortion of truth in an effort to enhance the competitive advantage of a client can be found intelligible, indeed compatible with other, more general, societal values. While no more morally justifiable than the values from which it draws its specious warrants, this professional policy and its allied practices appear to be necessary contraventions of that which is otherwise deemed morally impermissible. Thus, the legal professional can become allied implicitly with the theory that the general good is promoted best through the free pursuit of competing individual or group interests and by whatever means are available to enhance one's competitive advantage.[74] Relying on these sorts of considerations, and upon the presumptions created by their widespread and institutionalized character, it would not be difficult to find reasons to justify high levels of discretionary and seemingly arbitrary control by the professional participant in the process of determining whom to help when not all can be helped in the giving of legal aid. In this fashion, considerations arise which conspire to transform the question of what would constitute a fair distribution of free legal services into questions about what will assure the advantage of the professional, or what will exempt professionals from the reasonable requirement that the criteria of distribution be made explicit, general, and public.

Other potential candidates in this "conspiracy" of considerations also tend to override the requirements of distributive justice and tend to count as more important than reasons of fairness. While a

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[72]Abrams v. United States, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting).

[73]*See* MacRae, *supra* note 70, at 11.

[74]*See id.* at 3.

careful consideration of these "candidates" is beyond the scope of this Article, they can at least be noted, thereby pointing to the need for future analysis. Principally, these "candidates" are the more formal theories of legal justice which may serve to justify discretion and arbitrariness in allocation policies—the positivist and realist theories of justice.[75] From a positivist view of justice, allocation policies would be "fair" or "just" simply because they assign procedures for allocating legal aid. Just as what is merely statutory might be considered just, that which is merely procedural may also be considered fair. It is the policy and, from a positivist view of things, is therefore fair.[76] Similarly, a theory of legal realism, if consistent with its traditional interpretations of precedent and the social bases of "judge-made law," gives greater discretionary power to judges[77] and, by extension of the theory, to all who subscribe to such logic in the administration of legal aid.

In sum, theoretical as well as practical reasons, some professional, some cultural, incline attorneys to become discretionary in legal aid procedures. The following statement by J.H. Skolnick, although directed to the system of law enforcement, may also be applicable to allocation and access policies in the administration of justice:

> The legal order is popularly envisioned as the most formally normative of all social organizations because it contains a codified and carefully interpreted body of rules. But, in practice, it continues to be a *highly discretionary order* at every level, mediated by subtle, sometimes unarticulated, yet discernible norms held by actors in the system.[78]

C. Considerations Which Favor Procedural Over Substantive Fairness and Efficiency Over Equality in Screening Candidates

The legal aid movement, in both its private and in its publicly organized forms, bears witness to the conviction that every citizen is entitled to a day in court, irrespective of his ability to pay. Unfortunately, however, the resources necessary to assure either that the indigent will be represented or that the quality of the representation will be on a par with that of the opposing party are not always available. Thus, the fundamental and recurring scarcity of resources creates serious dilemmas, necessitates a strategy for screening candidates, and brings to the fore considerations which, because of

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[75]*See* 4 THE ENCYCLOPEDIA OF PHILOSOPHY, *supra* note 68, at 418-21.

[76]*Id.* at 419.

[77]*Id.* at 420-21.

[78]J. SKOLNICK, JUSTICE WITHOUT TRIAL, at iii (2d ed. 1975) (emphasis added).

their hold on the profession and our culture, may override substantive fairness and equality, or at least may set presumptions which serve to do the same.

The most commonly used eligibility rules demonstrate that lawyers, as most Americans, are commited heavily to the nonmoral value of efficiency in the use of resources.[79] Even the subject-matter tests discussed earlier, which serve several kinds of community goals, have as one of their principal purposes the efficient distribution of limited legal aid resources. Nonetheless, since there are different economic models of efficiency, the effort to achieve efficient results may also entail efforts to disown some of the results achieved.

Cost-benefit ratios and cost effectiveness measures are two of the most common instruments for calculating efficiency in the distributions of economic resources. Cost-benefit ratios typically measure quantifiable outcomes; for example, the numbers of clients served, as compared with the inputs or the quantities of resources expended in the process. Thus, they entail a commitment to the theory that the more served for the least amount is the most efficient, best system, and overlook considerations of which kinds of cases are either included or excluded. Cost effectiveness measures are concerned with how best to apply inevitably limited resources effectively in an effort to eradicate the causes of social injustice, rather than simply palliating their symptoms. Cost effectiveness considerations might prompt efforts for legislative reform and preference for precedent-setting cases rather than favoring headcounts of the numbers of clients served. An attachment to headcount efficiency may provide, therefore, a way of paradoxically disowning the results achieved—that is, to the extent the clients are represented in a system which is substantively unfair.

That a commitment to efficiency may lead to such odd consequences is partially due to its linkage with presumptions favoring procedural forms of seeking justice in American civilization and its legal profession. Ordinary people know full well the differences between form and substance, procedures and results. Yet, because of the nature of our legal system and the ways in which its licensed practitioners are introduced to and skilled in its techniques, lawyers are apt not only to confuse what the layman so readily observes, but are also accustomed to attempting to persuade laymen that fair play is all the system can assure, thereby blurring the fact that the advantages of the players are not always equal.

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[79]*See, e.g.*, Johnson, *supra* note 32, at 224 n.179. *See also* TIME, Sept. 25, 1978, at 59 (reporting the Yankelovich survey on California's Proposition 13).

One's day in court may become a mere procedural formality and a chimera of justice if one of the opponents has access to superior legal resources or if the conflict must be resolved under the terms and conditions set by fundamentally unfair laws or rules of procedure. Thus, a fair share of access to basic social opportunities or a fair opportunity to redress wrongs may be foreclosed by a prior and overriding commitment to only fair play under sometimes unfair game plans and rules.

Herein appears a curious and puzzling paradox. While committed to achieving results through the use of eligibility standards, the results in sight are nonmoral, efficient, and potentially purely procedural. Phrased differently, the efforts and expenditures prompted by moral convictions, embedded in constitutional assurances of equal protection, can, in striving to achieve moral ends, employ standards which are, in the final analysis, counterproductive. Through effective but facile and morally dubious weddings of convictions between the legal and the economic order, people can be guaranteed only the kinds of equal protection which comport with canons of efficiency and the formalities of fair play. Furthermore, since both of these orders are highly formal, technologically sophisticated, and frequently arcane for all but the professional jurist and economist, they acquire a sort of specious public validity and can be immune to challenges about the disparity between their values and those which are more general and public.

Convinced perhaps that legal conflicts are the sorts of human affairs in which no procedure can be found to guarantee results which always will meet the standards of substantive justice, the legal profession is hampered in its efforts to make legal counsel fully available. In approximating justice, and perhaps in settling too quickly the question of how much more nearly it can be achieved, attorneys can begin to extoll form over substance and can be persuaded too readily to equate the requirements of procedural due process with due justice or fairness. Fortified by judgments about the benefits anticipated from competitive adversarial advocacy and allied with similarly competitive economic and political models, one might be tempted to justify that which is only partially justifiable and to excuse the unpardonable or to disown the results achieved but creditable to "the system." This interlocking of professional and other cultural convictions can shortcircuit potential charges of unfairness. It can shield that which is merely de facto from penetrating questions. In assuring only efficiency and other nonmoral results, it can contravene the public reasons and expectations for which the system is licensed and sanctioned. Finally, if this is the best approximation of justice possible, the victories are pyrrhic ones indeed.

A rather obvious and distressing example of such a victory appears in cases of legislatively-established welfare rights in which, seemingly, one is entitled to only procedural due process. If, in *Goldberg v. Kelly*,[80] the Supreme Court was forced to define for the first time the precise intent of law in the realm of the welfare state, its decision may be far more conservative, formal, and purely procedural than is perceived commonly by those who applaud its radical or revolutionary character.[81] Relying upon adversarial methods to establish statutory rights and upon judicial procedures of review, the net gains of this decision may be more procedural than substantive. Although the case assures protection from arbitrariness and thus averts some of the problems noted in the preceding section of this Article, it assures only procedural access to the welfare system and, principally, a right only to litigate one's claims.[82] The pyrrhic character of this victory can be seen in two sets of consequences. One is that the funds for the litigation is drawn from the resources allocated to provide welfare benefits, thereby potentially decreasing resources for assistance by expending them to contest entitlements to those resources.[83] A second set of consequences includes temporary suspensions and inevitable delays in the actual receipt of benefits by all of the targeted beneficiaries while the procedures of the program are being contested by one or more of the potential, but now litigating, recipients.[84]

Akin to the pattern of the *Goldberg* decision, the decisions behind eligibility policies in legal aid reflect a bias toward proceduralism. Whether this presumption in favor of due process reflects a conviction that substantive fairness and equal access to legal aid are inevitable and necessary outcomes of procedurally fair criteria is not entirely clear. What is clear, however, is that, in subject-matter tests, at least, standards of eligibility do not always fully respect the requirements of distributive justice. Appearing to conform rather to standards of efficiency and procedural fairness, they both mirror and promote convictions about the overriding importance of economic efficiency and those socio-legal judgments which de-emphasize material differences in results by highlighting the more abstract, formal, and purely procedural aspects. This con-

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[80]397 U.S. 254 (1970).

[81]The Court, however, recognized the limited scope of its decision: "The constitutional issue to be decided, therefore, is the narrow one whether the Due Process Clause requires that the recipient be afforded an evidentiary hearing *before* the termination of benefits." *Id.* at 260.

[82]*See id.* at 267-71.

[83]*See* Verkuil, *The Search for A Legal Ethic: The Adversary System, Liberalism and Beyond*, 58 SOUNDINGS 54, 62-63 (1977).

[84]*See id.*

clusion does not suggest that procedurally fair rules cannot or do not ever have substantially fair results or that it has no respect whatever for materially sufficient criteria of justice. Rather, it states only that what is procedurally fair does not automatically achieve substantive fairness—and certainly not *because* it is a due process. The conclusion offered is that unmitigated and unconditioned confidence in the ability of rules of fair play to assure substantive fairness is not entirely warranted, and that our respect for it is due more to the prevalence and linking of widespread cultural convictions than to the intrinsic justifiability of the positions they support.

D. Beliefs and Practices Which Prompt Administrators of the Legal System to View Eligibility Questions as Matters Which Necessarily Entail Considerations of Merits and Deserts, Virtue or Vice, and Putative Social Harms

The enforcement of community or conventional morality can occur through administrative policy as well as through legislative and judicial proceedings. The more discretionary the policy, the more likely the possibility that conventional moral beliefs will be normative for, but not always surface in, decisions about eligibility, particularly if people or cases are categorized according to subjects. Subject-matter tests, even in less explicitly discretionary systems of legal aid, are subject to the twin dangers of every socially significant categorization—that they can conceal decisions inimical to certain groups of the populace and that they may entail socially stigmatizing judgments about those groups. Thus, while courting these social risks and while not being fully justifiable on a moral view of allocation policies, subject-matter tests and the prevalent beliefs they tend to favor enjoy a prima facie validity or moral plausibility. Subject-matter tests, because of their dependence upon and the reinforcement they receive from widely held but merely de facto beliefs about the treatment people on welfare "deserve"—such as the belief that people who seek a divorce or bankruptcy are less virtuous or potentially harmful to society and, therefore, less deserving—appear to be sensible discriminations between those well-deserving and those ill-deserving of assistance from relatively limited resources.

Although they are related to and potentially illuminating for this present discussion, the inquiry here is not primarily concerned with the general moral and philosophical questions raised by attempts to enforce community morality through legal means—namely, questions which ask whether law is an appropriate instrument for such aims, whether some areas of human conduct are in principle beyond legal sanction, and, finally, whether this is the proper

business of government. While setting aside a general discussion of these larger questions, it is apparent nonetheless that, as in the preceding section, this Article is concerned about them and seeks to address some aspects of them—but in more concrete terms and in the context of problems of eligibility. In these matters, we need to be concerned with tracking and evaluating the ways in which, and notwithstanding the answers to questions of principle, appeals to policy tend to function pragmatically as answers to the larger questions. Whatever one's general and principled stand on the enforcement of community morality—and in particular on the role of government in merely assuring freedoms and equal protection—it is quite possible that particular policies may contravene those principles and find as allies in this contravention, the professional and cultural convictions which offer specious support for that which seems otherwise unjustifiable. Among potential candidates of beliefs which may prompt administrators of law to judge that the merits, virtues, and social harmfulness of indigents are relevant, perhaps even decisive, considerations are some judgments at the heart of the common law tradition and some presumptions set by the systems of criminal justice and welfare.

The intellectual habits fostered by training in and through the practice of law are acknowledged widely as reasons for a certain professional myopia regarding broader social issues. They can also establish, however, prejudicial beliefs, or at least presumptions, which tend to favor existing and merely de facto convictions concerning *who* as well as *what* are either well-deserving or ill-deserving of public approval, legal sanction, and eventually free legal assistance. In its tacit ratification of judge-made law and the candor that implies about the social sources of court decision, the common law's tradition of relentlessly pursuing precedent and principle serves both to blunt legal imagination and to warrant as de jure what are merely prevalent cultural beliefs. Whereas moral inquiry takes these beliefs seriously, but then raises the critical questions which may serve to undermine their plausibility, legal reasoning may have available theoretical reasons and some practical procedures which serve in circular fashion to warrant conclusions by appealing to the sources from which they arose in the first place.

So habituated, professionals may be little inclined to ask which considerations *ought* to count and may be prone to ask rather exclusively which considerations *do* count. This point is made vividly in the rhetorical question: "Who can oppose giving less consideration to the slothful and lustful?" Indigent or not, by association with popular convictions about personally and socially harmful vices, those seeking help with bankruptcy or divorce can come to be regarded as ill-deserving. Considerations of need can be overturned,

if at all attended, and may give way to considerations of deserts or merits.

The Handler-Hollingsworth study detailed some of the ways in which this phenomenon can appear.[85] Studying certain nineteenth century, and perhaps still influential, criteria of welfare eligibility, the study concluded that these standards were based on a distinction between the poor and paupers, characterized respectively as indigent and morally degenerate, judging that the former were victims of fate while the latter were morally blameworthy.[86] This distinction and its supporting justifications became the basis for differential welfare treatment and provided a rationale for policies which sought either to deter or to penalize the deviant.[87] Given the strength of cultural traditions and widely accepted practices in the treatment of social deviants, it is not unreasonable to suppose that some analogous forms of thought are still influential and that they supply convenient justifications for restricting equality of opportunity and treatment, as well as for intervening in the affairs of and limiting the liberty of those stigmatized as deviant. Nor is it difficult to imagine that administrators might be inclined to attach overriding significance to considerations concerning the kinds of persons who need legal aid and regarding the kinds of putative harms society may be required to sustain if its deviants remain unchecked—indeed, are aided and abetted in using the system in legalized ways (for example, in litigation) which some may view as contributing to their delinquency.

Just as the welfare system and the gate-keeping done for it by the legal profession tend to import into their deliberations prevalent convictions about morally praiseworthy and blameworthy persons and then to differentiate treatments on that basis, so too does the criminal justice system. Whereas the deterrence and penalizing employed in the welfare system are more often, but not exclusively, psychological, their counterparts in the criminal justice system are more overtly and intentionally corporal or physical and, in some cases, capital. Setting aside these obvious differences, similar notions and common applications of principles can be found and identified in both of these social systems and in their allied and gatekeeping legal system.

Imputing liability and arguing for punishments deserved inevitably entail sizeable conceptual and normative puzzles about which more confusion than clarity prevails. A convenient and com-

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[85] J. HANDLER & E. HOLLINGSWORTH, THE "DESERVING POOR" (1971).

[86] *Id.* at 17-20.

[87] *See id. See also* J. GRAHAM, THE ENEMIES OF THE POOR 88-92 (1970); Silverstein, *supra* note 12, at 574; TIME, *supra* note 79.

mon method of avoiding these difficulties is to invoke certain preferred notions, maxims, and informal arguments, which, if culturally pervasive and if simultaneously legitimated by social systems such as the legal order, can become persuasive despite their ambiguity and indemonstrability. The terms and conditions set upon moral experience by virtue of being American do indeed set presumptions favoring liberty, but in some curious and not always consistent ways. While guaranteeing political rights favoring freedom from interference, Americans find good reasons, nonetheless, to limit liberty, particularly if potential conflicts with the rights of others or harms forthcoming to one's self or to society are perceived.

The most frequently invoked grounds for limiting liberty or for coercing compliance with convention are the prevention of harm to self, the prevention of harm to others and, in the extreme, the prevention or punishment of sin.[88] That harms are not always nor readily distinguished from that which simply fails to meet social wants or, for that matter, from that which merely offends prevalent sensibilities does not seem to deter confident and assertive declarations that certain behavior is clearly detrimental to society. That personal liability and the voluntariness required for moral blameworthiness cannot always be clearly determined in the face of other environmental factors does not seem sufficiently to slow the enthusiasm for finding a culprit, indeed a scapegoat, even at the risk of blaming the victim. The fact that "therapy," whether rehabilitative or deterrent, may, in fact, be a penalty or, if sufficiently stigmatized, a punishment[89] does not forestall effectively the occasional social impulse to make some people pay heavily for their failures as well as for the verifiable harms they inflict upon others.

Setting aside the temptation to consider here the possibility of a social pathology associated with these inclinations, a more modest point is asserted. These inclinations appear in and become normative at times in subject-matter tests of eligibility for legal aid and draw support from allied considerations in the welfare and criminal justice systems. The important point is not simply that these inclinations exist and tend to shape certain kinds of decisions and policies in those three systems. The point is that, when they are employed or appealed to in matters of legal-aid eligibility, they seem more plausible than they really are and manage to escape critical scrutiny *because* they fit comfortably in the web of alliances the common law tradition establishes with other social judgments of worth, merit,

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[88]J. FEINBERG, SOCIAL PHILOSOPHY 33 (1973). *See also* J. GUSTAFSON, PROTESTANT AND ROMAN CATHOLIC ETHICS 15-19 (1978) (discussing the possible Calvinistic overtones in "banning" offenders and imposing penalties on them).

[89]J. FEINBERG, DOING AND DESERVING 96-98 (1970).

and virtue. Thus, appealing to principles which themselves owe their authority to conventional beliefs, the justifications for considering judgments of this sort as a basis for making distinctions between people seeking legal aid can be warranted in a somewhat circular fashion. Furthermore, and leaving unattended for the moment other possible grounds for criticizing such a move, positions which make these sorts of appeals seem to err by subordinating right and wrong to the moral beliefs people happen to have—and in a rather systematic and socially interdependent fashion.[90]

V. Conclusion

This Article's close reading of eligibility rules, their implications and their alliance with social, political, and economic convictions has sought both to analyze their moral justification and to open avenues for continued critical reflection. It is difficult not to be impressed, however, with the formidable and inertial mass of interlocking power and value they represent. Although not always intellectually consistent and systematic, the bundle of presumptions favoring discretion, proceduralism, efficiency, and private codes of professional conduct has a pragmatic and functionally useful social coherence, and one which is sufficiently durable and supple to withstand anything less than a sustained critical reflection about its premises. Nonetheless, and hoping that the power of the de facto is not sufficient to paralyze one's sense of hope and efforts to progressively improve the legal system, I shall confess this hope and a commitment to these efforts as the premises upon which this inquiry began and from which it looks forward to increased collaboration with others who would move steadily in the direction of more nearly approximating the ideals of justice and liberty for all.

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[90] *See* Lyons, Book Review, 87 Yale L. Rev. 415, 435 (1977) (reviewing R. Dworkin, *supra* note 68).

Notes

Dual Capacity Doctrine: Third-Party Liability of Employer-Manufacturer in Products Liability Litigation

I. INTRODUCTION

The dual capacity doctrine has received growing attention in recent years.[1] This doctrine permits an employee to sue his employer for tortious conduct which emanates from a "non-employer" capacity.[2] It has become a viable means of circumventing the exclusive remedy provided by workmen's compensation[3] and has resulted in a careful re-evaluation of the precepts which have traditionally supported workmen's compensation legislation.

Although workmen's compensation was designed primarily to benefit the industrial employee and to protect him from many inequities present in an industrial society,[4] the employer has found the exclusive remedy provision to be an effective vehicle for escaping the full economic sanction which would have been levied at common

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[1]2A A. LARSON, THE LAW OF WORKMEN'S COMPENSATION § 72.80 (1976); Larson, *Workmen's Compensation: Third Party's Action Over Against Employer*, 65 NW. U.L. REV. 351 (1970); Malone, *The Limits of Coverage in Workmen's Compensation—The Dual Requirement Reappraised*, 51 N.C.L. REV. 705 (1973); O'Connell, *Workmen's Compensation as a Sole Remedy for Employees But Not Employers*, 28 LAB. L.J. 287 (1977); Vargo, *Workmen's Compensation, 1974 Survey of Recent Developments in Indiana Law*, 8 IND. L. REV. 289 (1974); Comment, *Tort—Workmen's Compensation—Dual Capacity Doctrine Rejected*, 8 MEM. ST. U.L. REV. 163 (1977); Comment, *Workmen's Compensation and Employer Suability: The Dual Capacity Doctrine*, 5 ST. MARY'S L.J. 818 (1974).

[2]2A A. LARSON, *supra* note 1, § 72.80, at 14-112; Vargo, *supra* note 1; Comment, *Workmen's Compensation and Employer Suability: The Dual Capacity Doctrine*, 5 ST. MARY'S L.J. 818 (1974).

[3]Workmen's compensation statutes specifically exclude any common law remedy of an employee against his employer for industry-related accidents. Provisions of this nature will typically state:

> The rights and remedies herein granted to an employee subject to this act [22-3-2-1 to -6-3] on account of personal injury or death by accident shall exclude all other rights and remedies of such employee, his personal representatives, dependents or next of kin, at common law or otherwise, on account of such injury or death.

IND. CODE § 22-3-2-6 (1976). *See generally* Note, *Workmen's Compensation Act—Bar of Common Law Recovery for Non-Compensable Injuries*, 14 N.C.L. REV. 199 (1936).

[4]1 A. LARSON, *supra* note 1, § 4.00 (1978); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 80 (4th ed. 1971); W. SCHNEIDER, SCHNEIDER'S WORKMEN'S COMPENSATION § 1 (3d ed. 1941), B. SMALL, WORKMEN'S COMPENSATION LAW OF INDIANA § 1.2 (1950). An early discussion of the social ramifications caused by the industrial society and the need for a workmen's compensation scheme can be found in Peet v. Mills, 76 Wash. 437, 136 P. 685 (1913). *See also* materials cited in note 14 *infra*.

law for his tortious conduct.[5] As a result, a number of jurisdictions have recognized exceptions which permit an employee, injured during his employment, to maintain a common law tort action against his employer under the dual capacity doctrine. Exceptions have been recognized in cases involving the malpractice of a doctor in providing treatment for injuries sustained at work by an employee,[6] cases involving insurance carriers of employers who have assumed responsibility for medical treatment[7] or safety inspection[8] at the place of employment, cases involving the intentional torts of an employer which result in injury to his employees[9] and cases involving a seaman's common law action against a shipowner for maintaining an unseaworthy vessel under the Longshoremen's and Harbor Workers' Compensation Act.[10]

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[5]*See* note 3 *supra.*

[6]*See, e.g.*, Duprey v. Shane, 39 Cal. 2d 781, 249 P.2d 8 (1952). *See also* 2A A. LARSON, *supra* note 1, § 72.80, at 14-112.

[7]*E.g.*, Mager v. United Hosps. of Newark, 88 N.J. Super. 421, 212 A.2d 664 (1965). *See also* 2A A. LARSON, *supra* note 1, § 72.90.

[8]*E.g.*, Sims v. American Cas. Co., 131 Ga. App. 461, 206 S.E.2d 121 (1974). *See also* 2A A. LARSON, *supra* note 1, § 72.90.

[9]*E.g.*, Conway v. Globin, 105 Cal. App. 2d 495, 233 P.2d 612 (1951). *See also* Note, *Right of Employee to Sue Employer for an Intentional Tort*, 26 IND. L.J. 280 (1951).

[10]33 U.S.C. §§ 901-50 (1976). Cases arising from this Act provide an analogous examination of the dual capacity theory. The Act's exclusive remedy provision bars any common law recovery against an employer by an injured seaman. Longshoremen's & Harbor Workers' Compensation Act, 33 U.S.C. § 905 (1976). Under prior law an employee-seaman was permitted to bring a common law action against his employer in a second capacity as owner of the ship under the doctrine of unseaworthiness, thereby circumventing the Act's statutory bar to these actions. Act of Oct. 27, 1972, Pub. L. No. 92-576, § 18(a), 86 Stat. 1263 (formerly codified at 33 U.S.C. § 905 (1970)); Reed v. The Yaka, 373 U.S. 410 (1963); Ryan Stevedoring Co. v. Pan Atlantic S.S. Corp., 350 U.S. 124 (1956); In Seas Shipping Co. v. Sieracki, 328 U.S. 85 (1946); Hertel v. American Export Lines, Inc., 225 F. Supp. 703 (S.D.N.Y. 1964). *See generally* 1A E. JHIRAD, BENEDICT ON ADMIRALTY § 27 (1977); 2A A. LARSON, *supra* note 1, § 72.80; Larson, *Conflicts Problem Between the Longshoremen's Act and State Workmen's Compensation Acts Under the 1972 Amendments*, 14 HOUS. L. REV. 287 (1977); Larson, *The Conflict of Laws Problem Between the Longshoremen's Act and State Workmen's Compensation Acts*, 45 S. CAL. L. REV. 699 (1972); Note, *Longshoremen, Longshoring Operations, and Maritime Employment: A Dual Test of Status After Northeast Marine Terminal Co. v. Caputo*, 64 VA. L. REV. 99 (1978).

It should be noted, however, that the 1972 amendments to the Act have created some uncertainty as to the current status of an employer-shipowner's common law liability to an injured seaman. *See* Johnson v. American Mut. Liab. Ins. Co., 559 F.2d 382 (5th Cir. 1977); Holland v. Allied Structural Steel Co., 539 F.2d 476 (5th Cir. 1976); Griffith v. Wheeling Pittsburgh Steel Corp., 521 F.2d 31 (3d Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); Haas v. 653 Leasing Co., 425 F. Supp. 1305 (D.C. Pa. 1977). *See also* G. GILMORE & C. BLACK, THE LAW OF ADMIRALTY § 6-57 (2d ed. 1975); Note, *The Injured Lognshoremen vs. The Shipowner After 1972: Business Invitees, Land-Based Standards, And Assumption of Risk*, 28 HASTINGS L.J. 771 (1977); 23 LOY. L. REV. 1029 (1977).

Because of the dynamic state of the law in this area and because its application of

In these cases, the employer has been treated as a third-party tortfeasor and has been held accountable for his tortious conduct. His third-party or "dual" liability has been the exception, however, and most jurisdictions have upheld the exclusive remedy and rejected the worker's common law action.[11] For example, the exception has not generally been extended to cases involving an employee's products liability action against his employer, who is also the manufacturer of the product which caused that employee's injury.[12] This adherence to the traditional exclusive remedy concept seems at odds with today's general expansion of a consumer's tort action against a manufacturer of defective products.[13]

This Note will first discuss the social tenets which support the workmen's compensation scheme. It will then analyze the justifications for the recognition of an employer's third-party liability in the exceptional cases and the problems associated with an extension of the dual capacity doctrine into the area of products liability litigation.

II. Development of A Workmen's Compensation Scheme

Workmen's compensation evolved from efforts to ameliorate the often inequitable and devastating effects of an industrial society.[14]

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a dual capacity theory is merely analogous to the employer-employee relationship under workmen's compensation, the relevance of dual capacity in the context of the Act will not be analyzed in the textual portion of this Note.

[11]2A A. Larson, *supra* note 1, §§ 72.80, 72.90.

[12]*See, e.g.*, Kottis v. United States Steel Corp., 543 F.2d 22 (7th cir. 1976), *cert. denied*, 430 U.S. 916 (1977).

[13]Analysis of the development of a consumer's tort action against a manufacturer has been undertaken by numerous commentators. *See* 2 L. Frumer & M. Friedman, Products Liability §§ 16, 16A (1978); W. Prosser, *supra* note 4, §§ 96-98; Calabresi & Hirschoff, *Toward A Test For Strict Liability in Torts*, 81 Yale L.J. 1055 (1972); Klemme, *The Enterprise Liability Theory of Torts*, 47 U. Colo. L. Rev. 153 (1976); Montgomery & Owen, *Reflections on the Theory and Administration of Strict Tort Liability for Defective Products*, 27 S.C.L. Rev. 803 (1976); Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 Yale L.J. 1099 (1960); Ribstein, *Guidelines for Deciding Product Economic Loss Cases*, 29 Mercer L. Rev. 493 (1978); Wade, *On the Nature of Strict Tort Liability for Products*, 44 Miss. L.J. 825 (1973). *See generally* Owen, *The Highly Blameworthy Manufacturer: Implications on Rules of Liability and Defense in Products Liability Actions*, 10 Ind. L. Rev. 769 (1977).

[14]W. Prosser, *supra* note 4, § 80; W. Schneider, *supra* note 4, § 1. *See* 1 A. Larson, *supra* note 1, § 2.20 (1978), wherein Professor Larson describes the underlying policy behind the workmen's compensation scheme as follows:

> The ultimate social philosophy behind compensation liability is belief in the wisdom of providing, in the most efficient, most dignified and most certain form, financial and medical benefits for the victims of work-connected injuries which an enlightened community would feel obligated to provide in any case in some less satisfactory form, and of allocating the burden of these

This scheme has replaced the common law tort action, once the sole recourse for an injured employee, with a statutory scheme which has generally abrogated principles of fault.[15] It has been designed to provide an expeditious remedy which will guarantee to the injured employee a minimum measure of recovery, instead of forcing him to battle his employer in a long and costly judicial proceeding which often leaves the worker with no recovery.[16]

The workmen's compensation scheme has rejected the common law defenses of contributory negligence, assumption of risk, and the fellow-servant rule.[17] These defenses had often acted to deprive an

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payments to the most appropriate source of payment, the consumer of the product.

Id. See also Brode, *The Adequacy of Workmen's Compensation as Social Insurance: A Review of Developments and Proposals*, 1963 WIS. L. REV. 57 (1963); Campbell, *Basic Principles of Workmen's Compensation*, 20 MISS. L.J. 117 (1949); Clayman, *Relation of Workmen's Compensation to Other Social Insurance*, 19 OHIO ST. L.J. 607 (1958); Grillo, *Fifty Years of Workmen's Compensation—An Historical Review*, 38 CONN. B.J. 239 (1964); Horovitz, *Modern Trends in Workmen's Compensation*, 21 IND. L.J. 473 (1946); Katz, *Workmen's Compensation in the United States*, 9 LAB. L.J. 866 (1958); Larson, *The Nature and Origins of Workmen's Compensation*, 37 CORN. L.Q. 206 (1952); St. Clair, *The Case for Private Insurance of Workmen's Compensation*, 31 ROCKY MTN. L. REV. 397 (1959).

[15]1A A. LARSON, *supra* note 1, § 30.00 (1973). Prosser has enumerated five common law duties of a master for the protection of his servants:

1. The duty to provide a safe place to work.
2. The duty to provide safe appliances, tools, and equipment for the work.
3. The duty to give warning of dangers of which the employee might reasonably be expected to remain in ignorance.
4. The duty to provide a sufficient number of suitable fellow servants.
5. The duty to promulgate and enforce rules for the conduct of employees which would make the work safe.

W. PROSSER, *supra* note 4, § 80, at 526 (footnotes omitted).

[16]W. PROSSER, *supra* note 4, § 80, at 530-31. One author recognizes three choices for dealing with industrial accidents: (1) Refuse all aid to the injured worker, thereby forcing him to bear the entire loss; (2) compensate the worker from general tax revenues by way of the various welfare programs; or (3) grant the worker benefits under an employer-financed workmen's compensation plan. 1 A. LARSON, *supra* note 1, § 2.20 (1978). Larson rejects the first choice as immoral. He objects to the welfare payments because, while they would spread the loss, they stigmatize the worker as a pauper and force the cost of the accident upon a governmental body unconnected with the industry causing the worker's injury. He approves the grant of workmen's compensation benefits because it preserves the worker's dignity and requires the industry which produced the injury to absorb the loss as a cost of production. *Id. See also* Horovitz, *Symposium: Worldwide Workmen's Compensation Trends*, 59 KY. L.J. 35 (1970-71); Kelly, *Workmen's Compensation—Still a Vehicle for Social Justice*, 55 MASS. L.Q. 251 (1970); Larson, *supra* note 14.

[17]Prior to workmen's compensation legislation, several jurisdictions had attempted to mitigate the effect of these defenses. *See* 1 A. LARSON, *supra* note 1, §§ 4, 5 (1978). A number of states have deprived an employer of these defenses if that employer has failed to comply with his state's workmen's compensation act (*i.e.*, by

employee of any recovery at common law.[18] One writer estimated the effect of these defenses on a worker's chance to recover at common law and concluded that eighty percent of all employee actions at common law were unsuccessful.[19] In the remaining twenty percent of the cases, recovery was often so small, after costs and attorney fees, that little compensation was received by the employee.[20]

The inequities found under the common law system led various states to exercise their police and sovereign powers to create a new remedy which operated to exclude all other remedies without regard to the fault of either the employer or employee. The result has been to treat industrial accidents as a cost of production.[21] One court has explained this result:

> The employer and employe as distinctive producing causes are lost sight of in the greater vision, that the industry itself is the great producing cause, and that the cost of an injury suffered in any industry is just as much a part of the cost of production as the tools, machinery, or material that enter into that production, recognizing no distinction between the injury and destruction of machinery and the injury and destruction of men in so far as each is a proper charge against the cost of production.[22]

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refusing to pay premiums into the state's workmen's compensation fund). *See* Spaulding v. Ads-Anker Data Systems-Midwest, Inc., 498 F.2d 517 (4th Cir. 1974) (applying W. VA. CODE § 23-2-8 (1978)). Other jurisdictions have deprived an employer of these defenses if that employer fails to obtain insurance as required by the state's workmen's compensation act. *See, e.g.*, Haralson v. Rhea, 76 Ariz. 74, 259 P.2d 246 (1953) (applying ARIZ. REV. STAT. § 23-907 (1971)).

[18]W. PROSSER, *supra* note 4, § 80, at 526-28. Prosser pointed out that the possibility of recovery by the injured workman was greatly limited by this "unholy trinity" of common law defenses. The employee was deemed either to have bargained away his right to hold the employer responsible or to have assumed the risk of hazards normally incident to the type of employment in which he was engaged. If the employee remained at work voluntarily after he knew and appreciated the danger, the employer was totally absolved from responsibility for any losses resulting from his breach of duty. This was true even if the employee continued to work under protest, or under a direct order carrying a threat of discharge. It was only if the risk was not imminent, and the employer gave an assurance of safety or a promise to remedy the hazard, that the workman was held not to assume the risk by remaining on the job. *See generally* Moreland, *The General Development of Workmen's Compensation Acts*, 13 KY. L.J. 20 (1924).

[19]B. SMALL, *supra* note 4, § 1.2, at 3 (citing W. DODD, ADMINISTRATION OF WORKMEN'S COMPENSATION, 21 (1936)). Dean Prosser cited other estimates of the pre-workmen's compensation recovery rates for industrial accidents. *See* W. PROSSER, *supra* note 4, § 80 n.32.

[20]B. SMALL, *supra* note 4, § 1.2, at 3.

[21]1 A. LARSON, *supra* note 4, § 2.20 (1978); W. PROSSER, *supra* note 4, § 80, at 530-31; 1 W. SCHNEIDER, *supra* note 4, § 3.

[22]Peet v. Mills, 76 Wash. 437, 440, 136 P. 685, 686 (1913).

The net effect of workmen's compensation, therefore, has been to impose a form of strict liability upon the employer to pay for industrial accidents.[23] It has shifted the loss of accident away from the employee, who is unable to bear the loss of injury, and has forced the industry to absorb that loss.[24]

It should be noted that workmen's compensation is not designed as a general accident insurance[25] but as a means of compensating an employee for losses resulting from a risk to which an employee is exposed by his employment in the industry.[26] Workmen's compensation operates to: (1) Assure that the injured employee will receive necessary hospital and medical care and a modest but certain compensation for his injury, and (2) afford the employer immunity from the potentially exorbitant common law tort claims of his employee.[27] Workmen's compensation creates a new loss-spreading mechanism which is more stable, predictable, and efficient than traditional forms of recovery available at common law. It replaces a judicial determination of injury, administered by a jury by reference to the specific facts of each case, with a legislative determination, administered by an industrial board and governed by standardized criteria and uniform recovery rates.[28]

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[23]W. PROSSER, *supra* note 4, § 80, at 531. This form of strict liability should not be confused with that involving "ultrahazardous activities." Professor Larson distinguished the two forms in 1 A. LARSON, *supra* note 1, §§ 2.20, 2.30 (1978).

[24]*See* W. PROSSER, *supra* note 4, § 80, at 530-31.

[25]*See* 1 W. SCHNEIDER, *supra* note 4, § 5, at 13-14 which states:

> Primarily the acts are intended to provide financial protection against workmen and their dependents becoming public charges because of the risks and hazards of the workmen's employment, by assuring them the compensation prescribed by the acts, through substituting in most instances a method of insurance in place of common law liability.

See generally 1 A. LARSON, *supra* note 1, § 3 (1978). Larson distinguished workmen's compensation legislation from public-social insurance schemes. He pointed out that workmen's compensation does not place the loss upon the public as a whole, as would public-social insurance, but rather places the loss upon a particular class of consumers, thereby retaining a relation between the risk of industry and the ultimate loss-bearer.

[26]*See* Employers Mut. Liab. Ins. Co. of Wis. v. Konvicka, 197 F.2d 691 (5th Cir. 1952); Lewis v. W.B. Lea Tobacco Co., 260 N.C. 410, 132 S.E.2d 877 (1963). *Compare* O'Connell, *supra* note 1, *with* Malone, supra note 1. *See also* Riesenfeld, *Forty Years of American Workmen's Compensation*, 35 MINN. L. REV. 525, 529 (1951).

[27]This dichotomous function has been recognized in several jurisdictions. *See* Smither & Co. v. Coles, 242 F.2d 220, 222 (D.C. Cir.), *cert. denied*, 354 U.S. 914 (1957); Provo v. Bunker Hill Co., 393 F. Supp. 778, 780-81 (D. Idaho 1975); Reed v. New England Tel. & Tel. Co., 175 F. Supp. 409, 410 (D.N.H. 1959); Sanchez v. Hill Lines, Inc., 123 F. Supp. 42, 44 (D.N.M. 1954) (quoting Bradford Elec. Light Co. v. Clapper, 286 U.S. 145 (1932)); Wilson v. Faull, 27 N.J. 105, 116, 141 A.2d 768, 774 (1958); Fallone v. Miscericordia Hosp., 23 A.D.2d 222, 227, 259 N.Y.S.2d 947, 952 (1965), *aff'd*, 17 N.Y.2d 648, 216 N.E.2d 594, 269 N.Y.S.2d 431 (1966). *See also* 1 W. SCHNEIDER, *supra* note 4, § 4.

[28]These concepts and recovery schedules are embodied in most workmen's com-

The focal point of a workmen's compensation analysis is the *employment* relationship—the status of the parties as employer and employee.[29] If the employment relationship exists, the provisions of the workmen's compensation scheme apply. The courts have generally construed the language of workmen's compensation statutes liberally in order to bring an injured employee within the protection of the statutes[30] and to increase the employer's immunity from common law actions.[31]

A further prerequisite to the recovery of workmen's compensation benefits is that a direct causal connection must exist between the employment relationship and the injury.[32] It is not sufficient for an award of compensation that the injury befell the worker while he was "on the job."[33] Rather, the causal connection will be deemed to exist only if the accident which results in injury is found to "arise

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pensation statutes. *See, e.g.*, IND. CODE § 22-3-3-8 (1976), dealing with awards for total disability arising from job-related injuries, which states in part:

> With respect to injuries occurring on and after July 1, 1976, causing temporary total disability or total permanent disability for work, there shall be paid to the injured employee during the total disability a weekly compensation equal to sixty-six and two-thirds percent (66 2/3%) of his average weekly wages . . . for a period not to exceed five hundred (500) weeks.

See also Comment, *The Test for the Employment Relationship Under Workmen's Compensation*, 1 U.C.L.A.-ALAS. L. REV. 40, 44 (1971).

[29]*See generally* 1B A. LARSON, *supra* note 1, § 43.00-.54 (1978). As a general rule, the test for determining whether an employment relationship exists is the employer's "right to control" the worker's conduct, as distinguished from the right merely to require certain results in conformity with a contract. *See* Lawson v. Lawson, 415 S.W.2d 313, 319 (Mo. App. 1967); Myers v. Workmen's Compensation Comm'r, 150 W. Va. 563, 567, 148 S.E.2d 664, 667 (1966); Sears, Roebuck & Co. v. Poole, 112 Ga. App. 527, 527-28, 145 S.E.2d 615, 616 (1965); Travelers Ins. Co. v. Arnold, 378 S.W.2d 78, 82 (Tex. Civ. App. 1964). *Compare* Edelston v. Builders & Remodelers, Inc., 304 Minn. 550, 550-51, 229 N.W.2d 24, 25 (1975), wherein the court considered the following factors in determining the existence of an employment relationship: (1) The right to control the means and manner of performance, (2) the mode of payment, (3) the furnishing of materials or tools, (4) the control of the work site, and (5) the right to discharge, *with* RESTATEMENT (SECOND) OF AGENCY § 220(2) (1958), which enumerates several factors relevant to the determination of an employment status. *See also* Comment, *supra* note 28.

[30]*See* New England Tel. & Tel. Co. v. Central Vt. Pub. Serv. Corp., 391 F. Supp. 420, 428 (D. Vt. 1975); Loveless v. Garrison Furniture Co., 251 Ark. 776, 779, S.W.2d 158, 160 (1972); Prater v. Indiana Briquetting Corp., 253 Ind. 83, 86, 251 N.E.2d 810, 811 (1969); Keenan v. Young, 119 Ohio App. 233, 235, 195 N.E.2d 382, 385 (1963). *See generally* Campbell, *supra* note 14, at 126-29.

[31]*See* Arnold v. Shell Oil Co., 419 F.2d 43 (5th Cir. 1969); Liles v. Riblet Prods. of La., Inc., 363 F. Supp. 358 (W.D. La. 1973); Johnson v. Wisconsin Lumber & Supply Co., 203 Wis. 304, 234 N.W. 506 (1931).

[32]1 A. LARSON, *supra* note 1, §§ 6.00, 6.10 (1978); Larson, *The Legal Aspects of Causation in Workmen's Compensation*, 8 RUTGERS L. REV. 423 (1954).

[33]Malone, *supra* note 1, at 711.

out of" *and* "during the course of" employment.[34] "Arising out of" involves the risk or hazard to which the employee would not have been exposed had he not been performing the duties or incidental tasks of employment.[35] "During the course of" deals with the time and place of the accident and the circumstances under which the accident occurred.[36] Many jurisdictions have treated these terms in conjunction and permitted recovery only when both are found to exist.[37]

Therefore, before a worker will be entitled to recover workmen's compensation benefits, he must show: (1) An employment relationship between the employer and himself, and (2) an accident which arose out of and during the course of employment. Once these two tests have been met, then, except for a few narrowly drawn exceptions, workmen's compensation eliminates both the relevance of fault and the worker's common law action in tort against his employer. With this background in mind, the dual capacity doctrine will now be examined.

III. Dual Capacity Doctrine

As noted above, workmen's compensation was designed to alleviate many of the hardships faced by an employee at common law.[38] In return for a guaranteed recovery of benefits, the employer was given immunity from further liability to his employee.[39] It has become apparent, however, that the employer has taken refuge in this statutory immunity and has thereby avoided certain tort claims which arguably do not result from the employment relationship. The dual capacity doctrine has been designed to correct this anomaly. The doctrine entitles an employee to recover from his employer if

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[34]*See* Burnett, *Workmen's Compensation Claims "Arising Out of" and "In the Course of,"* 2 Forum 35 (1966); Larson, *supra* note 32; Malone, *supra* note 1; Comment, *"Arising Out of" and "In the Course of Employment" in Workmen's Compensation*, 28 Tenn. L. Rev. 367 (1961).

[35]1 A. Larson, *supra* note 1, §§ 6.00-.50 (1978). Larson recognized three prevailing tests for determining whether an injury "arises out of" the risk of employment: (1) *Increased-risk doctrine*—the employment increases the risk to the workman, not shared generally by the public; (2) *actual-risk doctrine*—the employment subjects a worker to an actual risk of harm, even if that risk is common to the public as a whole; and (3) *positional-risk doctrine*—the injury would not have occurred *but for* the fact that the employment placed the worker in the position in which he was injured. *Id.*

[36]*Id.* § 14. The question of whether the injury occurred on the employer's premises is only one factor to consider in determining the existence of a causal relationship between the accident and the employment relationship. *See, e.g.*, Jack v. Belin's Estate, 149 Pa. Super. Ct. 531, 27 A.2d 455 (1942).

[37]*See, e.g.*, Lincoln v. Whirlpool Corp., 151 Ind. App. 190, 279 N.E.2d 596 (1972).

[38]W. Prosser, *supra* note 4, § 80.

[39]*See* W. Schneider, *supra* note 4, § 4.

that employer occupies a second capacity conferring on him rights and obligations independent and unrelated to those generated by his capacity as employer.[40]

The controlling factor in a dual capacity analysis is the nature of the duty owed by the employer to his employees. As one writer has put it: "The decisive dual-capacity test is not concerned with how separate or different the second function of the employer is from the first but with whether the second function generates obligations unrelated to those flowing from the first, that of employer."[41] If the duty flows from the employment relationship and the injury "arises out of" and "during the course of" that employment, then the strong policy considerations behind workmen's compensation mandate that the employer be immune from tort liability. If, however, the duty flows from an "extra" employer status *or* does not "arise out of" and "during the course of" the employment, then a second capacity arises and the employer's status is merely coincidental.[42] The employer will then be treated as a third-party tortfeasor and will not be immune from a common law tort action by his employee.[43]

The third-party liability of the employer has been recognized in several jurisdictions. As noted above, this liability has been found in cases involving a physician-employer who negligently treats an employee,[44] insurance carrier cases,[45] cases involving an employer's intentional torts[46] and seamen claims under the Longshoremen's and Harbor Workers' Compensation Act.[47] Much has been written on an employer's dual liability in these areas and, therefore, the subject will not be discussed here. A brief examination of the policy supporting an acceptance of the dual capacity theory is, however, germane to an evaluation of the merits of rejecting this theory in the area of products liability litigation.

A. Physician-Employer's Negligent Treatment of His Employees

Several jurisdictions have held that if an employer-physician negligently treats his employee for injury "arising out of" and "during the course of" employment, the statutory immunity provided by workmen's compensation will not bar that employee's tort claim

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[40]*See* 2A A. LARSON, *supra* note 1, § 72.80.

[41]*Id.* at 14-117.

[42]*See* Mercer v. Uniroyal, Inc., 49 Ohio App. 2d 279, 361 N.E.2d 492 (1976).

[43]2A A. LARSON, *supra* note 1, § 72.80. Larson recognized two prongs to a dual capacity analysis: (1) Whether a valid dual capacity situation exists, and (2) which of the two capacities should control. *Id.* at 14-122.

[44]*See* note 6 *supra.*

[45]*See* notes 7 & 8 *supra.*

[46]*See* note 9 *supra.*

[47]*See* note 10 *supra.*

against his employer.[48] Since the employer assumes an obligation not required by either the employment relationship or the workmen's compensation statute, his status shifts from that of an employer to that of a third party.[49] Thus, the duty owed the employee emanates from the physician-patient relationship and not the employer-employee relationship.[50] The coincidental status of employer as physician does not affect the legal obligations owed to his employee.[51]

In *Duprey v. Shane*,[52] the California Supreme Court recognized that a dual capacity should not be blindly ignored in order to protect an employer's immunity under workmen's compensation. It stated:

> It is true that the law is opposed to the creation of a dual personality, where to do so is unrealistic and purely legalistic. But where, as here, it is perfectly apparent that the person involved—Dr. Shane—bore towards his employee two relationships—that of employer and that of doctor—there should be no hesitancy in recognizing this fact as a fact. Such a conclusion, in this case, is in precise accord with the facts and is realistic and not legalistic.[53]

Duprey supports the proposition that the exclusive remedy provision should be adhered to only if the policy considerations supporting the workmen's compensation scheme are invoked by the facts of a particular case. If, however, adherence to this provision works an inequity and deprives a workman of a tort action solely because of the coincidence that his physician was also his employer, then the exclusive remedy no longer facilitates the workmen's compensation scheme and mere "legal adherence" to that scheme is unjustified.

B. Employer's Insurance Carrier's Negligent Provision of Medical Services to Employees

A number of jurisdictions have considered cases in which an employer has contracted with an insurance carrier to provide medical services for his employees. Although many courts have rejected an employee's action against a carrier for negligently pro-

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[48]*See, e.g.*, Duprey v. Shane, 39 Cal. 2d 781, 249 P.2d 8 (1952) (upholding judgment in favor of injured employee against employer-physician for malpractice in treatment of industry-related injury).

[49]2A A. LARSON, *supra* note 1, §§ 72.61, 72.80.

[50]*Id.*; *see* Note, *The Malpractice Liability of Company Physicians*, 53 IND. L.J. 585 (1978).

[51]2A A. LARSON, *supra* note 1, §§ 72.61, 72.80.

[52]39 Cal. 2d 781, 249 P.2d 8 (1952).

[53]*Id.* at 793, 249 P.2d at 15.

viding medical services,[54] several jurisdictions have recognized this right.[55] In *Tropiano v. Travelers Insurance Co.*,[56] an employee brought an action in trespass against his employer's workmen's compensation carrier for negligence in supplying medical treatment for injuries sustained while acting within the scope of employment. The Pennsylvania Supreme Court reversed a lower court ruling[57] which had upheld the employer's immunity under the state law requiring an employer or his insurance carrier to furnish medical services to employees for work-related injuries.[58] The Pennsylvania Supreme Court concluded that the carrier's negligent treatment was not causally linked to the employment itself. It stated:

> The medical treatment of injuries is a separate and distinct function of the insurance carrier which does not concern the employer and is not part of the employer's business operations. The alleged acts of negligence in this case were committed by the insurance carrier subsequent to and independent of the original injury and with no involvement of the employer whatsoever.[59]

The carrier, by assuming duties independent of those imposed by the employment relationship, placed itself outside the workmen's compensation scheme and was not immune from tort liability.

A simliar result has been reached in cases involving the negligence of a physician who served the employer on a regular basis.[60] The ground for denying immunity to the doctor was that he served as an independent contractor, and was therefore a third party under the workmen's compensation scheme.[61]

Some jurisdictions have also refused to extend the employer's immunity to insurance carriers if those carriers maintain their own hospitals and clinics, and if nothing in the workmen's compensation

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[54]Sarber v. Aetna Life Ins. Co., 23 F.2d 434 (9th Cir. 1928); Flood v. Merchants Mut. Ins. Co., 230 Md. 373, 187 A.2d 320 (1963). *Cf.* Unruh v. Truck Ins. Exch., 7 Cal. 3d 700, 498 P.2d 1063, 102 Cal. Rptr. 815 (1972) (refusing to extend employer immunity so as to bar plaintiff's intentional tort claim against the carrier for failure to properly supervise and control investigators it hired to conduct a nonmedical investigation of plaintiff-employee's claim for compensation).

[55]Mager v. United Hosps. of Newark, 88 N.J. Super. 421, 212 A.2d 664 (1965); Tropiano v. Travelers Ins. Co., 455 Pa. 360, 319 A.2d 426 (1974); McKelvy v. Barber, 381 S.W.2d 59 (Tex. 1964); Potter v. Crump, 555 S.W.2d 206 (Tex. Civ. App. 1977).

[56]455 Pa. 360, 319 A.2d 426 (1974).

[57]*Id.* at 363, 319 A.2d at 427, *rev'g* 227 Pa. Super. Ct. 487, 303 A.2d 515 (1973).

[58]77 PA. CONS. STAT. ANN. §§ 1-1603 (Purdon 1952 & Supp. 1978-79).

[59]455 Pa. at 363, 319 A.2d at 427.

[60]*See, e.g.*, McKelvy v. Barber, 381 S.W.2d 59 (Tex. 1964).

[61]*Id.* at 62-63. *See also* Potter v. Crump, 555 S.W.2d 206 (Tex. Civ. App. 1977).

statute requires that these separate clinics be maintained.[62] If the provision of clinical services is undertaken voluntarily in an effort to reduce costs and achieve immunities under workmen's compensation, it has generally been held in these jurisdictions that the carrier is entitled to no immunity under the workmen's compensation statute.[63]

Despite these and similar cases allowing recovery, most courts have refused to permit a common law action against an insurance carrier who negligently provides medical services for its employer. By granting immunity to the carrier, these courts have treated the employer and carrier as "one" entity if: (1) Its treatment proximately results from an injury "arising out of" and "during the course of" employment, and (2) the services are rendered pursuant to a statute which provides that the carrier is not a third party under the act.[64] In the latter situation, however, the employee may retain a common law right to sue the individual physician or hospital for its malpractice.[65]

C. Injury Resulting from Employer's Insurance Carrier's Negligent Safety Inspection

Authority is divided on the question of liability by an insurance carrier for negligent inspection of an employer's working premises which results in the injury of an employee.[66] Some courts have denied the employee a common law action against the carrier for negligent inspection.[67]

In *Bartolotta v. Liberty Mutual Insurance Co.*,[68] employees sustained personal injuries when overcome by argon gas while making repairs in a cylindrical chamber on the employer's premises. As the employer's workmen's compensation carrier, Liberty Mutual reserved the right to inspect the employer's place of business and did make inspections on a number of occasions. The plaintiff argued that his injuries resulted from Liberty Mutual's negligent inspection and

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[62]*See, e.g.*, Mager v. United Hosps. of Newark, 88 N.J. Super. 421, 212 A.2d 664 (1965) (holding that an employee was entitled to bring an action for malpractice against a clinic maintained by and for the employer's workmen's compensation carrier).

[63]*Id.* at 427, 212 A.2d at 667-78.

[64]*See* Flood v. Merchants Mut. Ins. Co., 230 Md. 373, 187 A.2d 320 (1963).

[65]2A A. LARSON, *supra* note 1, § 72.61.

[66]*See generally* Comment, *Workmen's Compensation—The Carrier's Reserved Right of Inspection and the Injured Employee*, 16 DEPAUL L. REV. 89 (1966).

[67]*See* Mustapha v. Liberty Mut. Ins. Co., 268 F. Supp. 890 (D.R.I. 1967), *aff'd per curiam*, 387 F.2d 631 (1st Cir. 1967); Donohue v. Maryland Cas. Co., 248 F. Supp. 588 (D. Md. 1965), *aff'd per curiam*, 363 F.2d 442 (4th Cir. 1966); Matthews v. Liberty Mut. Ins. Co., 354 Mass. 470, 238 N.E.2d 348 (1968).

[68]411 F.2d 115 (2d Cir. 1969).

failure to report the dangerous condition to the employer. Liberty Mutual moved to dismiss the action alleging that it was acting as the employer's legal representative when making inspections. It claimed that this capacity entitled it to employer immunity under Connecticut's Workmen's Compensation Act.[69] The trial court granted Liberty Mutual's motion to dismiss and the decision was affirmed by the Second Circuit on appeal.[70]

The court found Liberty Mutual to be the "alter-ego" of the employer under Connecticut law and, therefore, entitled to employer immunity.[71] It stated that the Connecticut legislature intended to extend the employer's immunity to the insurance carrier, and to hold otherwise would result in the discouragement of voluntary inspections by such carriers.[72] The court further determined that an insurance carrier should share equally in the benefits and immunities of an employer if it undertakes the employer's duty to make safety inspections.[73] The court distinguished those cases in which the carrier's negligence is unrelated to its role as compensation carrier from those cases in which the inspections for the employer are clearly within the scope of its function as insurance carrier.[74] This is particularly significant if the carrier's conduct does not increase the risk of accident to the employee.[75]

The trend in numerous jurisdictions has been away from the holding in cases like *Bartolotta*.[76] In *Sims v. American Casualty Co.*,[77] the Georgia Court of Appeals reversed a lower court's dismissal of an action brought by a mother against an insurance carrier for the wrongful death of her son. The son had been killed during the course of employment when volatile alcohol-based products ignited. The court held that a wrongful death action was not barred by the payment of death benefits to the mother under workmen's compensation.[78] The court further held that the carrier would be liable in tort for failure to use reasonable care and skill in conduct-

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[69]CONN. GEN. STAT. §§ 31-275, -293, -340 (1961).

[70]411 F.2d at 119.

[71]*Id.* at 116.

[72]*Id.* at 117.

[73]*Id.* at 119.

[74]*Id.* at 118-19.

[75]The court stated: "[T]here is no liability unless the negligent performance or nonperformance is either relied upon by the injured party or increases the risk of harm." *Id.* at 119.

[76]*See* Ruth v. Bituminous Cas. Corp., 427 F.2d 290 (6th Cir. 1970); Mays v. Liberty Mut. Ins. Co., 323 F.2d 174 (3d Cir. 1963); Sims v. American Cas. Co., 131 Ga. App. 461, 206 S.E.2d 121 (1974), *aff'd per curiam*, 232 Ga. 787, 209 S.E.2d 787 (1974); Nelson v. Union Wire's Rope Corp., 31 Ill. 2d 69, 199 N.E.2d 769 (1964).

[77]131 Ga. App. 461, 206 S.E.2d 121 (1974).

[78]*Id.* at 478, 206 S.E.2d at 133.

ing safety inspections,[79] even if inspections were undertaken pursuant to contractual or statutory obligation.[80] *Bartolotta* considered the insurance carrier to be "one" with the employer and immune from tort liability for its negligent inspection, *Sims*, on the other hand, determined that the carrier occupied a dual status with differing obligations and liabilities flowing from each status.[81]

The *Sims* court cited Professor Larson's treatise on workmen's compensation[82] for the proposition that an insurance carrier may be liable as a third-party tortfeasor if its negligence results in injury to an employee.[83] Larson believes that a distinction should be drawn between a carrier's duty to provide benefits and services and duties which it might assume in the way of direct performance of services related to the act.[84] The carrier shares the employer's immunity for breach of the first duty, whereas the carrier is liable as a third-party tortfeasor for breach of the latter duty.[85]

Most important, the *Sims* court recognized two competing fundamental ideals at work when an employer or carrier's liability as a third-party tortfeasor becomes an issue: "The one is the original idealistic compensation theory that the whole industrial problem should be 'swept within' the compensation act. The other is the even more ancient principle that common law rights of action shall not be deemed abolished except by clear statutory language."[86] These two competing viewpoints are at the heart of the dual capacity analysis. As the court indicated, if the policy goals sought to be furthered by the workmen's compensation scheme do not exist, then strict adherence to the exclusive remedy provision is less warranted. Thus, the workmen's compensation statute should not insulate an employer or carrier from its liability as a "non-employer" tortfeasor.

D. Employer's Intentional Torts Against His Employees

An employer will be subject to civil action for his intentional torts resulting in injury to his employees. The general rule has been that workmen's compensation will be the exclusive remedy if the employee's injury is fairly traceable to an incident of employment[87]

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[79]*Id.* at 469, 206 S.E.2d at 127-30.

[80]*Id.* at 473, 206 S.E.2d at 130.

[81]*Id.*

[82]2A A. LARSON, *supra* note 1, § 72.90.

[83]131 Ga. App. at 476-77, 206 S.E.2d at 132.

[84]2A A. LARSON, *supra* note 1, § 72.90, at 14-151.

[85]*Id.*

[86]131 Ga. App. at 478, 206 S.E.2d at 133 (quoting 2A A. LARSON, *supra* note 1, § 72.90).

[87]*See* Flanagan v. Ethyl Corp., 390 F.2d 30 (3d Cir. 1968); Ulicny v. National Dust Collector Corp., 391 F. Supp. 1265 (E.D. Pa. 1975); Burkhart v. Wells Elecs. Corp., 139 Ind. App. 658, 215 N.E.2d 879 (1966).

but will not operate to foreclose common law recovery for injury connected to personal grievances unrelated to the employment relationship.[88] This rule has been premised upon the traditional notion that workmen's compensation deals only with industry-related injuries which "arise out of" and "during the course of" employment.[89] Workmen's compensation does not include injuries which result from an employer's willful, unlawful, or malicious wrongs.[90]

An employer's intentional torts have been handled under workmen's compensation in three ways. First, through legislative enactments, some workmen's compensation acts contain provisions which expressly reserve common law remedies for injuries resulting from an employer's willful acts of misconduct.[91] Second, other jurisdictions provide increased benefits under the workmen's compensation scheme for intentional torts.[92] Finally, some workmen's compensation legislation gives an employee a right to pursue his remedy under either workmen's compensation or at common law.[93]

The basis for departing from the exclusive remedy of workmen's compensation is the concept that an employer who intentionally inflicts bodily injury upon his employee severs the employment relationship and should no longer be permitted to claim immunity under the workmen's compensation act.[94] One court has held that to permit an employer to claim immunity for injury resulting from his intentional wrongs would sanction conduct which is both tortious and criminal.[95] Further, it would shield him from liability for conduct which is independent of the employment relationship and not within the scope of the workmen's compensation scheme.[96]

In these cases, as in the cases involving the physician-employer or insurance carriers,[97] the policies and goals which support workmen's compensation are not affected if the accident does not "arise out of" and "during the course of" employment. Thus, if the obligations owed the employee by the employer flow from a "non-employment" relationship, the employee should not be forced to look

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[88]*See* Conway v. Globin, 105 Cal. App. 2d 495, 233 P.2d 612 (1951); Readinger v. Gottschall, 201 Pa. Super. Ct. 134, 191 A.2d 694 (1963).

[89]Readinger v. Gottschall, 201 Pa. Super. Ct. 134, 191 A.2d 694 (1963).

[90]*Id. See also* Artonio v. Hirsch, 4 Misc. 2d 42, 157 N.Y.S.2d 398 (Sup. Ct. 1956), *modified & aff'd*, 3 A.D.2d 939, 163 N.Y.S.2d 489 (1957).

[91]*See, e.g.*, Heskett v. Fisher Laundry & Cleaners Co., 217 Ark. 350, 351-52, 230 S.W.2d 28, 29 (1950); 81 AM. JUR. 2d *Workmen's Compensation* § 55 nn.62-64 (1976).

[92]81 AM. JUR. 2d *Workmen's Compensation* § 55 nn.62-64 (1976).

[93]*Id.*

[94]*E.g.*, Boek v. Wong Hing, 180 Minn. 470, 231 N.W. 233 (1930).

[95]Conway v. Globin, 105 Cal. App. 2d 495, 498, 233 P.2d 612, 614 (1951).

[96]*Id.*

[97]*See* notes 6-8 *supra*.

to workmen's compensation as his only remedy. This seems to be particularly true if the employer's second capacity was voluntarily assumed and not mandated by either contractual or statutory dictate. With these precepts in mind, an analysis of the efficacy of the dual capacity doctrine in the area of products liability litigation will now be undertaken.

IV. Dual Capacity Doctrine in Products Liability Litigation

The development of case law in the area of workmen's compensation has been paralleled by an expanding body of law involving a manufacturer's liability for his defective products.[98] The former has emerged to deal with inequities resulting from industrial accidents, the latter has challenged the problems of consumer-related injuries. This has resulted in the creation of separate mechanisms for disbursement of economic losses.

In cases involving industry-related accidents, workmen's compensation has replaced an employee's common law tort claim against his employer with a statutory scheme. This scheme has created a loss-disbursement mechanism which shifts the loss from an industrial accident onto the industry which has created the risk of employment.[99] Inadequacies in the common law remedy, combined with an employer's significant control over working conditions, have led to this result. The courts have sought to construe liberally workmen's compensation benefits.[100] The increased predictability and reduced delay in obtaining recovery are thought to benefit both the employer and worker and thereby enhance the economic climate in which industry must develop.

The consumer of manufactured goods has found himself in circumstances analogous to those faced by the industrial employee. The manufacturer controls the design and manufacture of his products and forces the consumer to rely upon the quality of those goods.[101] The consumer, as a general rule, has little opportunity or knowledge with which to inspect the product to determine the existence of quality defects.[102] Therefore, like the industrial employee

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[98]*See* note 13 *supra*.

[99]W. Prosser, *supra* note 4, § 80, at 530-31.

[100]*E.g.*, New England Tel. & Tel. Co. v. Central Vt. Pub. Serv. Corp., 391 F. Supp. 420 (D. Vt. 1975).

[101]*See* Restatement (Second) of Torts § 402A, Comment c (1977); Green, *Strict Liability Under Sections 402A and 402B: A Decade of Litigation*, 54 Tex. L. Rev. 1185 (1976); Wade, *On the Nature of Strict Tort Liability for Products*, 44 Miss. L.J. 825 (1973).

[102]*See* Henningsen v. Bloomfield Motors, Inc., 32 N.H. 358, 161 A.2d 69 (1960); Santor v. A&M Karagheusian, Inc., 44 N.J. 52, 207 A.2d 305 (1965). Justice Traynor in his dissenting opinion in Escola v. Coca Cola Bottling Co., 24 Cal. 2d 453, 150 P.2d 436

who has little control over the risk inherent in employment, the consumer has little control over the risk inherent in the product. Furthermore, the consumer has traditionally faced a number of legal obstacles in bringing an action against the manufacturer for injuries resulting from defective products. Privity,[103] disclaimers of warranty,[104] statutes of limitation[105] and the burden of proving fault[106] have been common impediments to a consumer's claim against a manufacturer.

As a result, legislatures and courts have begun to reduce the obstacles facing a consumer in bringing a tort action against a manufacturer. The adoption in many states of section 402A of the *Restatement (Second) of Torts*[107] has spurred this movement. Section 402A has assisted the consumer in sustaining his burden of proof by eliminating fault principles and imposing a form of strict liability upon the manufacturer who introduces an unreasonably defective product[108] into the stream of commerce.[109] In addition, section 402A has eliminated privity as a defense to a consumer's action.[110] Development under this section has resulted in an expansion of the concept of "consumer" beyond the actual purchaser of a product so as to include all foreseeable users of a product.[111] This has been

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(1944) noted the changes in the relationship between manufacturer and consumer:

> As handicrafts have been replaced by mass production with its great markets and transportation facilities, the close relationship between the producer and consumer of a product has been altered. Manufacturing processes, frequently valuable secrets, are ordinarily either inaccessible to or beyond the ken of the general public. The consumer no longer has means or skill enough to investigate for himself the soundness of a product, even when it is not contained in a sealed package, and his erstwhile vigilance has been lulled by the steady efforts of manufacturers to build up confidence by advertising and marketing devices such as trade-marks.

Id. at 467, 150 P.2d at 443 (Traynor, J., dissenting). *See generally* Dickerson, *The ABC's of Products Liability-With a Close Look at Section 402A and the Code*, 36 TENN. L. REV. 439, 440 (1969); Wade, *Strict Tort Liability of Manufacturers*, 19 SW. L.J. 5 (1965).

[103]2 L. FRUMER & M. FRIEDMAN, *supra* note 13, § 16A [5].

[104]*Id.*

[105]*Id.*

[106]*Id.*

[107]RESTATEMENT (SECOND) OF TORTS § 402A (1977).

[108]*See* 2 L. FRUMER & M. FRIEDMAN, *supra* note 13, § 16A[4][g]; W. PROSSER, *supra* note 4, §§ 98-99; Keeton, *Product Liability and the Meaning of Defect*, 5 ST. MARY'S L.J. 30 (1973); Traynor, *The Ways and Meanings of Defective Products and Strict Liability*, 32 TENN. L. REV. 363 (1965); Vargo, *Products Liability in Indiana—In Search of a Standard for Strict Liability in Tort, Symposium: 1977 Products Liability Institute*, 10 IND. L. REV. 871 (1977); Wade, *A Conspectus of Manufacturers' Liability for Products, Symposium: 1977 Products Liability Institute*, 10 IND. L. REV. 755 (1977).

[109]Vargo, *supra* note 108.

[110]*See generally* W. PROSSER, *supra* note 4, § 98.

[111]*See* RESTATEMENT (SECOND) OF TORTS § 402A, Comment l (1977).

predicated upon the belief that a manufacturer can better anticipate, prevent, and spread any loss resulting from a defective product than can a consumer who has little control over the risk involved in using that product. The loss is, therefore, shifted to the manufacturer to be spread throughout the industry rather than to the consumer.[112]

Workmen's compensation and section 402A thus represent two loss-disbursement mechanisms designed to impose liability upon the manufacturer or employer, parties which have traditionally benefited from the fault concept. In recent years, however, there has emerged a slight overlap of these two mechanisms. Cases evidencing this fact generally involve an employee who is injured during his employment by products defectively manufactured by his employer. The employer has in most instances argued that the worker must look to workmen's compensation for his exclusive remedy because the accident occurred during the worker's employment. With increasing frequency, however, the worker has relied upon the dual capacity doctrine by bringing suit against the employer in his "non-employer" capacity as manufacturer of the defective product.

An example will serve to illustrate this problem. Assume *A* is in the business of manufacturing punch presses and *B* is employed by *A* to operate a press so manufactured by *A*. Under the prevailing view, if *B* is injured while operating that press due to a defect in the manufacture or design caused by *A*, *B*'s sole remedy will be under workmen's compensation and he will be barred from bringing a products liability action against *A*. If, however, *B* was employed by *C* to operate a press at *C*'s plant (assume that *A* also manufactured this press) and was injured because of a defect in that press, then *B* would be eligible to recover workmen's compensation benefits from *C* and also be permitted to sue *A* in a products liability action.

Advocates of *A*'s tort liability to *B* argue that *A* enjoys two relationships to *B*; one of employer and one as manufacturer of the product which caused *B*'s injury. They argue that separate obligations flow from each status and that separate liabilities should, therefore, exist. Although this logic makes a compelling argument for the application of the dual capacity doctrine, the doctrine has generally been rejected on the grounds that the best interest of the employee will be served if the workmen's compensation remedy is accepted and the common law remedy rejected.[113]

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[112]*See* Greenman v. Yuba Power Prods., Inc., 59 Cal. 2d 67, 377 P.2d 897, 27 Cal. Rptr. 697 (1963); 2 L. FRUMER & M. FRIEDMAN, *supra* note 13, § 16A[1]; RESTATEMENT (SECOND) OF TORTS § 402A, Comment c (1977).

[113]*See* Kottis v. United States Steel Corp., 543 F.2d 22 (7th Cir. 1976), *cert. denied*, 430 U.S. 916 (1977); Lewis v. Gardner Eng'r Corp., 491 S.W.2d 778 (Ark. 1973); Williams v. State Comp. Ins. Fund, 50 Cal. App. 3d 116, 123 Cal. Rptr. 812 (1975); Needham v. Fred's Frozen Foods, Inc., 359 N.E.2d 544 (Ind. Ct. App. 1977).

In *Provo v. Bunker Hill Co.*,[114] an employee, while working in his employer's smelter plant, received severe burns when molten zinc blew from an uncovered pot. The employee received workmen's compensation benefits, and then instituted an action against Bunker Hill for negligence in failing to provide its employees with safe equipment. The employee attempted to separate the various duties flowing from the employer's status by asserting the dual capacity doctrine. Bunker Hill answered the employee's complaint by asserting the exclusive remedy provision of Idaho's Workmen's Compensation Act[115] as a defense and moved for summary judgment.

The United States District Court granted judgment for Bunker Hill and rejected the dual capacity rationale. The court held that the duty of an employer to provide safe machinery cannot be separated from his general duties as employer.[116] It further held that, if the accident "arises out of" and "in the course of" employment, any violation of the employer's duty is compensable under the Idaho Act regardless of fault.[117] The employer was, therefore, found to be immune from the worker's tort claim.[118] The court stated that the purpose of workmen's compensation is to provide the employee a certain and expeditious remedy and to supply the employer a limited and determinative liability.[119] It concluded: "[A]nything that tends to erode the exclusiveness of either the liability or the recovery strikes at the very foundation of statutory schemes of this kind, now universally accepted and acknowledged."[120]

Although *Provo* is not a products liability case, it does demonstrate a general preference for the workmen's compensation remedy and indicates that the consumer loss-disbursement mechanism is perceived as antagonistic to the goals of the workmen's compensation scheme. This preference has resulted in a refusal to substitute the consumer loss-disbursement mechanism, prevalent in the products liability field, for the workmen's loss-disbursement mechanism created by the workmen's compensation scheme.

Three arguments have been advanced by opponents of the dual capacity doctrine in the products area: (1) Even though the employer shares a second capacity as manufacturer, an employment relationship exists and the employee's injury is, therefore, within the con-

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[114]393 F. Supp. 778 (D. Idaho 1975).

[115]IDAHO CODE § 72-203 (1977).

[116]393 F. Supp. at 787.

[117]*Id.*

[118]*Id.*

[119]*Id.* at 780-81.

[120]*Id.*

templation of the workmen's compensation act;[121] (2) the employee's injury "arises out of" and occurs "during the course of" employment and, therefore, any dual status of the employer is merely coincidental and should not affect an employer's immunity under the workmen's compensation act;[122] and (3) to permit a tort action against the employer in his capacity as manufacturer would emasculate the policy supporting workmen's compensation by reintroducing principles of fault into a determination of the employer's liability.[123] Each of these arguments will be analyzed to determine their merit in light of the dual capacity theory.

A. Existence of an Employment Relationship

The first argument suggests that an employee must look to workmen's compensation if his injury occurs during his employment relationship. Therefore, he cannot circumvent the exclusive remedy provided by the workmen's compensation scheme separating the various roles or "dual" capacities of the employer.

In *Kottis v. United States Steel Corp.*,[124] a craneman employed by United States Steel was killed at United States Steel's plant. It was undisputed that the death "arose out of" and "during the course of" the employment and that the dependents of Kottis had received benefits under Indiana's Workmen's Compensation Act.[125] Kottis' estate brought an action against United States Steel alleging a dual capacity theory. The administratrix argued that United States Steel occupied two capacities in addition to that of an employer, namely: (1) Owner of the land upon which Kottis was killed, and (2) manufacturer of the crane on which the accident occurred. She contended that United States Steel owed its employees, as owner of the land, a duty of care that was owed to invitees to discover defects or dangerous conditions on its premises, and that as manufacturer it had a duty to manufacture products which were reasonably safe for their intended use.

The Seventh Circuit affirmed the district court's summary dismissal in favor of United States Steel[126] and held that the action against United States Steel, in its capacity as manufacturer, was barred by the exclusive remedy provided by the Indiana compensa-

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[121]*See, e.g.*, Kottis v. United States Steel Corp., 543 F.2d 22 (7th Cir. 1976), *cert. denied*, 430 U.S. 916 (1977).

[122]*E.g.*, Needham v. Fred's Frozen Foods, Inc., 359 N.E.2d 544 (Ind. Ct. App. 1977).

[123]*See, e.g.*, Lewis v. Gardner Eng'r Corp., 254 Ark. 17, 491 S.W.2d 778 (1973).

[124]543 F.2d 22 (7th Cir. 1976), *cert. denied*, 430 U.S. 916 (1977).

[125]IND. CODE § 22-3-2-1 to 6-3 (1976 & Supp. 1978).

[126]543 F.2d at 22.

tion act.[127] The court found that the employment relationship predominated and that injury resulting from the use of a crane was precisely the type of injury that workmen's compensation was intended to cover.[128] It stated that the Indiana compensation statute specifically abolished common law actions against an employer,[129] noting that the dual capacity argument does considerable violence to the statutory language "which abrogates 'all other rights and remedies . . . at common law or otherwise, on account of such injury or death' except those against 'some other person than the employer and not in the same employ'."[130] In addition, the court pointed out that an employer's failure to provide a safe working environment had been a major claim in pre-workmen's compensation cases and was one basis of employer liability which workmen's compensation was designed to eliminate.[131] The court determined: "Allowing a remedy in addition to workmen's compensation for such cases would make substantial, if not devastating, inroads on the Indiana workmen's compensation scheme."[132]

The Seventh Circuit recognized that an employer may assume various roles in relation to his employees, but determined that generally these roles were sufficiently within the employment relationship to be unseverable and thus exclusively covered by Indiana's compensation act. The problem with this approach, however, is that the employer's assumption of a manufacturer's status was not necessitated by either the employment contract or the workmen's compensation scheme. This is the same issue faced in the cases involving an insurance carrier's voluntary establishment of a clinic or hospital for its own benefit to mitigate costs and achieve possible immunities under the workmen's compensation statutes.[133] As discussed above, some jurisdictions have held that insurance carriers under these circumstances are unable to claim an employer's immunity from a malpractice action if the establishment of clinics was calculated to benefit the carriers and was not a duty created by the employment contract or workmen's compensation scheme.[134] Applying the same rationale to the duties voluntarily assumed by an employer in using his manufactured goods at his place of business, it

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[127]*Id.* at 24. Indiana's exclusive remedy provision is found in IND. CODE § 22-3-2-6 (1976).

[128]543 F.2d at 26.

[129]*Id.* at 24.

[130]*Id.*

[131]*Id.* at 26.

[132]*Id.*

[133]*E.g.*, Mager v. United Hosps. of Newark, 88 N.J. Super. 421, 212 A.2d 664 (1965).

[134]*Id.* at 667.

would seem that such duties do not flow from the employment relationship. The employer should not, therefore, be immune to an employee's products liability action.

Opponents of the dual capacity doctrines argue that to permit application of the doctrine in products liability litigation would result in increased efforts to predicate tort liability upon the many "non-employer" functions which might arise. This would arguably lead to numerous exceptions to an employer's immunity and, thereby, undermine a primary objective of workmen's compensation—providing the worker a guaranteed recovery in return for employer immunity from further economic liability. It should be noted, however, that the dual capacity rationale has been adopted only when alternate social goals have been found to exist. For example, some decisions have implied that the strong social need for competence in medical treatment by employer-physicians outweighs the social benefits which would result from an employer's immunity under workmen's compensation.[135] Proponents of the dual capacity doctrine might argue that an employer's immunity should not bar an action against an employer who assumes a second capacity and, thus, incurs these social obligations. This would be particularly true if that second capacity is voluntarily assumed to improve an employer's economic position at the expense of his employees.

There may also be constitutional problems in the grant of tort immunity to an employer-manufacturer under workmen's compensation. Equal protection of the law may bar a result which permits a manufacturer to escape tort liability to its employees while permitting all other users, including employees of third-party employers, to maintain a products liability action against the manufacturer. As noted above, workmen's compensation is to apply only if the injury "arises out of" and "during the course of" employment. If, however, the employment relationship is merely coincidental and the employer's duty flows from a manufacturer-foreseeable user relationship rather than one of employer-employee, arguably, no legal basis exists for treating the two classes of employees differently.

B. Effect of "Arising out of" and "During the Course of"

The dual capacity concept has also been defeated in products liability litigation by advocates alleging that the employee's injury "arose out of" and "during the course of" employment and was, therefore, within the contemplation of the workmen's compensation

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[135]*See, e.g.*, Duprey v. Shane, 39 Cal. 2d 781, 789, 249 P.2d 8, 14 (1952); Smith v. Golden State Hosp., 111 Cal. App. 667, 672, 296 P. 127, 129 (1931). *See also* Comment, *supra* note 2, at 822.

scheme. This differs from the first argument in that the former focuses on the status of the parties as employer-employee and the existence of an employment relationship. The second argument assumes an employment relationship and focuses on the specific nature of risk created by that employment.

In *Needham v. Fred's Frozen Foods, Inc.*,[136] an employee brought an action against his employer for injuries sustained because a pressure cooker which he had been cleaning exploded and sprayed him with scalding grease. The Indiana Court of Appeals affirmed a lower court dismissal of the worker's action against his employer for the negligent manufacture of the pressure cooker.[137] The plaintiff argued that he should be permitted an independent cause of action against his employer for manufacturing a defective product which he used in the course of employment. He argued that the defendant's liability resulted from a capacity which created obligations apart from those imposed by the employer-employee relationship and that the exclusive remedy provision of Indiana's Workmen's Compensation Act[138] should not bar his action.

The Indiana court held that, if an employee's injuries "arise out of" and "in the course of" employment, then they are of the type which the workmen's compensation statute was designed to cover.[139] It concluded that the trial court's rejection of the dual capacity doctrine was proper.[140]

Although *Needham*[141] and *Kottis*[142] describe the injury as "arising out of" and "during the course of," it is not clear that they have adequately distinguished between these two concepts. Rather, they apparently, have used these terms singularly to refer to injuries occurring because of the employment relationship. Such a treatment seems inconsistent with other holdings which have recognized a conceptual difference between these terms.[143] As previously discussed, "arising out of" refers to the cause of injury or the source of the risk of employment.[144] "During the course of," on the other hand,

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[136]359 N.E.2d 544 (Ind. Ct. App. 1977).

[137]*Id.* at 545.

[138]IND. CODE § 22-3-2-6 (1976).

[139]359 N.E.2d at 545.

[140]*Id.*

[141]359 N.E.2d 544 (Ind. Ct. App. 1977).

[142]543 F.2d 22 (7th Cir. 1976), *cert. denied*, 430 U.S. 916 (1977).

[143]*E.g.*, Lincoln v. Whirlpool Corp., 151 Ind. App. 190, 195, 279 N.E.2d 596, 599 (1972) wherein the court stated:

> The statutory term[s] "arising out of" and "in the course of" are not synonymous. They are conjunctive terms. The term "arising out of" refers to the origin and cause of the "accident." The term "in the course of" refers to the time, place and circumstances under which the "accident" occurred.

See generally Malone, *supra* note 1.

[144]*See* 1 A. LARSON, *supra* note 1, § 6.00 (1978).

refers to the circumstances under which the accident occurred and the actions of the employee at the time of injury.[145]

If this conceptual difference is accepted, *Needham* and *Kottis* do little to resolve the issue posed by the dual capacity argument. In both cases the injury occurred "during the course of" employment in that the employee was working at his employer's place of business, using his employer's equipment, and performing at his employer's direction. It does not appear, however, that the injuries "arose out of" the employment. In both cases, the risk flowed from an employer's voluntary use of products which he had manufactured, and did not flow directly from the employment relationship. In light of this anaylsis, *Kottis* and *Needham* are arguably at odds with the general requirement that both forms of risk must be found to exist before the workmen's compensation scheme becomes applicable.[146]

C. Undermining the Workmen's Compensation Scheme

Opponents of the dual capacity doctrine finally argue that recognition of an employer's dual liability will revive the principles of fault which the workmen's compensation scheme was designed to eliminate. It is argued that these fault concepts will, in the long run, mitigate, rather than enhance, an employee's chance to recover for industry-produced injuries.

In *Lewis v. Gardner Engineering Corp.*,[147] the Arkansas Supreme Court rejected an employee's products liability claim. The employee had been injured by a malfunctioning hoist clamp manufactured by Gardner Engineering, one of two companies engaged in the joint venture which employed Lewis. The plaintiff argued that workmen's compensation immunities extended to members of the joint venture only if a member was acting within the scope of the joint venture. Plaintiff sought recovery, not for Gardner Engineering's failure to provide safe equipment, but for its negligence as a third party for manufacturing and using a faulty device outside the purposes of the joint venture.

The court stated the general rule that an employee of a joint venture is an employee of each joint venturer and that workmen's compensation provides employer immunity for each venturer.[148] It stated that Gardner Engineering was responsible for payment of workmen's compensation benefits only.[149] The court further stated

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[145]*Id.* § 14.

[146]*See generally* 1 A. LARSON, *supra* note 1, § 6.00, 6.10 (1978); Comment, *supra* note 28.

[147]254 Ark. 17, 491 S.W.2d 778 (1973).

[148]*Id.* at 18, 491 S.W.2d at 779.

[149]*Id.* at 19, 491 S.W.2d at 780.

that it was only a coincidence that Gardner Engineering was also manufacturer of the hoist clamp which had caused Lewis' injury.[150]

The majority opinion inspired a strong dissent which rejected the notion that Gardner Engineering's capacity as manufacturer was merely a coincidence. The dissent argued that Gardner Engineering was acting outside the scope of its duties as an employer because nothing in either the contract creating the joint venture or the Arkansas Workmen's Compensation Act[151] required an employer to furnish equipment which it had designed and manufactured.[152] The dissent advocated acceptance of the dual capacity doctrine[153] and stated:

> The remedy under the act is made exclusive . . . [but] this applies only to liabilities arising out of the employer-employee relationship. We have said that the purpose of the act is to compensate only for losses resulting from risks to which the fact of engaging in the industry exposes the employee. Birchett v. Tuf-Nut Garment Mfg. Co., 205 Ark. 483, 169 S.W.2d 574. Liability under the act is based, not upon any act or omission of the employer, but upon the existence of the relationship which the employee bears to the employment because of and in the course of the employment. . . . [W]e should not extend the limitation on the injured employees' remedy beyond the purposes of the act or beyond the constitutional limitation on the act. Failure to recognize the dual capacity doctrine in this case does both.[154]

The dissent concluded that a common law cause of action should be preserved unless clear statutory language abolishes that action,[155] and that any doubt should be resolved in favor of preserving rather than abolishing that right of action.[156]

Under this view, the goals supporting workmen's compensation are in no way frustrated by adopting the dual capacity doctrine and by permitting the employee to sue the employer in his "dual" capacity of manufacturer. One writer has expanded upon this position and stated:

> The plain intent of current compensation schemes is to protect the employee for injuries which occur in the course of

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[150] *Id.*

[151] ARK. STAT. ANN. §§ 81-1301 to 1363 (1939).

[152] 254 Ark. at 21, 491 S.W.2d at 780 (Fogleman, J., dissenting).

[153] *Id.* at 22, 491 S.W.2d at 781 (Fogleman, J., dissenting).

[154] *Id.* at 27, 491 S.W.2d at 784 (Fogleman, J., dissenting).

[155] *Id.* at 22-26, 491 S.W.2d at 781-83 (Fogleman, J., dissenting) (citing 2A A. LARSON, *supra* note 1, § 72.80, at 14-123).

[156] *Id.* at 26, 491 S.W.2d at 783 (Fogleman, J., dissenting).

> his employment while also preserving his right to bring third-party actions. A third-party action should be no less viable because the duty owed by the tortfeasor springs from an extra-relational capacity of the employer rather than arising from another third-party. All the reasons supporting the justness of recovering from third parties generally can be assembled to support dual-capacity liability. The employee, in accepting employment, can be presumed to have accepted all the conditions of his employment obvious to him and to have implicitly or explicitly agreed to the workmen's compensation compromise. But he cannot be presumed to have waived his right to bring common law actions against negligent third parties who coincidentally share the role of employer.[157]

The theory behind the dual capacity doctrine, advocated by the *Lewis* dissent, was adopted in *Mercer v. Uniroyal, Inc.*[158] In that case, the Ohio Court of Appeals reversed a lower court's summary dismissal of a products liability action against Uniroyal and the American Stevedoring Corporation.[159] The plaintiff, an employee of American Stevedoring Corporation, worked as a truck driver. He was injured while riding in a truck leased by Uniroyal from Avis Truck Rental while on a hauling trip for Uniroyal. The truck's left front tire, manufactured by Uniroyal, blew out, resulting in a collision and injuries to the plaintiff. A lease agreement existed between American Stevedoring and Uniroyal whereby American Stevedoring furnished its employees to Uniroyal. Uniroyal then had control of the truck drivers in all phases of its hauling operations. Under the agreement, American Stevedoring paid the drivers' wages, payroll taxes, and workmen's compensation and employer's liability insurance.

The plaintiff charged Uniroyal with a breach of express and implied warranties in the manufacture of the defective tire. He alleged that the cause of action was not subject to summary judgment under Ohio's Workmen's Compensation Act[160] because "it did not arise out of the employer/employee relationship."[161] The plaintiff also alleged that he did not seek recovery against Uniroyal in its capacity as employer for negligence, but sought recovery from Uniroyal in its capacity as manufacturer of a defective product. Further, he brought his action, not as an employee, but as a reasonably foreseeable user of a defective product.

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[157]Comment, *supra* note 2, at 831-32.

[158]49 Ohio App. 2d 279, 361 N.E.2d 492 (1976).

[159]*Id.* at 286, 361 N.E.2d at 496.

[160]OHIO REV. CODE ANN. § 4123.74 (Page 1973).

[161]49 Ohio App. 2d at 282, 361 N.E.2d at 494-95.

The court accepted the dual capacity theory[162] and found the risk created by Uniroyal's defective product to be one not necessarily of employment, but one common to the public in general.[163] It stated that if the initiating cause is not a risk of the employment relationship, there can be no causal connection between the employment and the injury.[164] Therefore, the exclusive remedy provision of workmen's compensation cannot bar a products liability action for injury not falling within the scope of the workmen's compensation scheme.[165]

The court seems to have rejected the argument that recognition of the dual capacity doctrine in the area of products liability litigation would act to emasculate the workmen's compensation scheme. Rather, it pointed to the realities of industrial life and implied that the dual capacity of an employer, as a basis for common law liability, might be essential to facilitate the goals of the workmen's compensation scheme. The court stated:

> It was only a matter of circumstance that the tire on the truck in which the plaintiff was riding was a Uniroyal tire rather than a Sears, Goodyear or Goodrich. In recent years, corporations and employers have entered a variety of fields and economic factors have promoted diversification rather than specialization. Conglomerates have become the rule. A corporation's economic structure should not dictate the right of the injured to recover or that each new corporate merger erases a like number of causes of action. For the foregoing reasons, the second assignment of error is well taken. Plaintiff should have his opportunity to establish a cause of action based upon product liability.[166]

The majority opinion was criticized in a dissent which argued that the plaintiff should be barred from a common law recovery for two reasons: (1) Plaintiff had received workmen's compensation benefits for injuries and should, therefore, be estopped from maintaining a common law action for damages on any extra-statutory theory, and (2) the Ohio workmen's compensation statute rejects the dual capacity doctrine by providing an exclusive remedy for industry-related injuries. The dissenting justice challenged the view that common law causes of action should be preserved unless destroyed by express statutory language. Instead, he argued that

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[162] *Id.* at 285, 361 N.E.2d at 496.

[163] *Id.*

[164] *Id.*

[165] *Id.* at 286, 361 N.E.2d at 496.

[166] *Id.* at 285-86, 361 N.E.2d at 496.

the workmen's compensation scheme should be applied liberally in granting immunity to complying employers and that any doubt should be resolved in favor of preserving, rather than abolishing, the statutory right of immunity.[167]

V. CONCLUSION

The general view which rejects the dual capacity doctrine in products liability litigation indicates a belief that the long term goals of workmen's compensation will be facilitated only through a strict compliance with those statutes and by a liberal construction of the exclusive remedy provision in order to reduce common law claims. If a common law remedy *is* to be recognized against an employer who acts in a capacity of manufacturer, then the majority view consistently has been to let the change occur through legislative action or constitutional amendment.[168]

The problem with the majority view, however, is that it considers the dual capacity doctrine to be antagonistic to the perpetuation of the workmen's compensation scheme. This conclusion may not necessarily be warranted because, under both workmen's compensation or a consumer rights theory, the ultimate goal is to reduce the burden of recovery faced by the employee or consumer, and to shift any loss onto the industry that created the initial risk of injury. By rejecting the dual capacity doctrine, the employer is permitted to escape full liability for the defective manufacture of goods simply by using those goods in his own plant. This becomes especially important since employer diversification might cause a number of employees, who are employed by the manufacturer, to be limited to a workmen's compensation remedy even though the nature and scope of the employment is quite unrelated to the manufacturer-employer's business of producing goods. The employee, an intended and foreseeable user, must, therefore, bear the full loss under the consumer loss-disbursement mechanism, while a non-employee party can force that loss onto the manufacturer. Thus, a smaller loss will usually be shifted onto the industry through the worker loss-disbursement mechanism of workman's compensation than that which would be shifted if the consumer loss-disbursement mechanism were to be invoked.

In addition, there might be some deterrent value to imposing tort liability upon the employer-manufacturer.[169] If an employer can

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[167]*Id.* at 290, 361 N.E.2d at 498 (Wiley, J., dissenting in part).

[168]*See, e.g.*, Needham v. Fred's Frozen Foods, Inc., 359 N.E.2d 544, 545 (Ind. Ct. App. 1977).

[169]This argument was discussed in Comment, *supra* note 2, at 832.

shield himself from losses caused by his defective products, simply by occupying a second capacity of employer, he will have little incentive to correct the dangerous condition produced by the defect. In fact, an employer might reap several benefits at the expense of his employees by using his own manufactured products. He might reduce the cost of machinery by not purchasing from another manufacturer. More important, he might find it cheaper to risk an industrial accident and to pay workmen's compensation benefits than to replace the defective machinery.[170] Such a result would seemingly defeat a major goal of the workmen's compensation scheme: to better the industrial environment and to facilitate economic growth within that industry.

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[170]Vargo, *Workmen's Compensation, Survey of Recent Developments in Indiana Law*, 8 IND. L. REV. 289, 294-95 n.34 (1974). The author hypothesized:

> It is very unlikely that an employer, faced with enormous expense, would voluntarily alter his business in order to provide a safe place for an employee to work. For example, assume the following facts. An employer owns an unsafe machine costing several million dollars. In order to sustain his business, he must continue to operate the machine. Its unsafe condition does not interfere with its efficiency; however, its condition is dangerous to the employees. While it would cost several hundred thousand dollars to repair the unsafe condition of the machine, the maximum cost of compensation for injury or death to an employee is only thirty thousand dollars. In such a situation, although the thought processes of the employer may not amount to a cold calculation of mere costs when considering the safety of his employees, cost must be a factor that would at least subconsciously influence his choice.

Federal Income Tax Discrimination between Homeowners and Renters: A Proposed Solution

I. INTRODUCTION

The first income tax bill was passed in 1861[1] as a means of financing the Civil War. Since that time, controversy has surrounded this form of taxation. Early debate centered on the justice (or injustice) of an income tax.[2] Later, opponents challenged the constitutionality of a direct tax on income and won.[3] The addition of the sixteenth amendment to the Constitution in 1913[4] settled the constitutional issue and ended, as a practical matter, debate over the existence of the tax itself. More recent controversy has focused upon the inequities of the income tax laws.[5] Internal Revenue Code provisions for deductions, exemptions, and preferential treatment of certain types of income prevent the achievement of what economists call horizontal equality:[6] people with equal income do not pay equal tax.

One of the most frequently criticized inequities in the current Code is the preferential tax treatment granted to homeowners and

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[1]Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 309 (1861) [hereinafter cited as the Civil War income tax]. The income tax was renewed yearly through 1871 and then was allowed to lapse.

[2]For a lively account of the verbal storm raised by the Civil War income tax, see R. PAUL, TAXATION IN THE UNITED STATES 8 (1954). Paul quotes the *New York Tribune*'s description of the tax as "the most odious, vexatious, inquisitional, and unequal of all our taxes," with a tendency to "tax the quality out of existence." *Id.* at 25. Commissioner Pratt's report of 1866 describes the forebearance of the American people:

> We may search in vain in our own history, or that of other nations, for such an example of patience and patriotism as was exhibited by the people of this country in the payment of these extraordinary burdens. They were prosperous and therefore willing to pay. The nations of the Old World regarded us with wonder and affected sorrow.

Id. at 29.

[3]Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895).

[4]U.S. CONST. amend. XVI.

[5]*E.g.*, Bittker, *Income Tax Deductions, Credits and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193 (1973); Blum, *Federal Tax Reform—Twenty Questions*, 41 TAXES 672 (1963); Frost, *Inequalities of the Federal Income Tax*, 23 CASE & COM. 818 (1917); Hackett, *The Constitutionality of the Graduated Income Tax Law*, 25 YALE L.J. 28 (1916); Jensen, *The Historical Discrimination of the Federal Income Tax Rates*, 54 TAXES 445 (1976); Wormser, *Some Reflections on Our Progressive Rate Income Tax System*, 53 A.B.A. J. 28 (1967); Note, *Income Taxation: A Plea for Genuine Reform*, 4 IND. LEGAL F. 362 (1970).

[6]White & White, *Horizontal Inequality in the Federal Income Tax Treatment of Homeowners and Tenants*, 18 NAT'L TAX J. 225 (1965).

denied to renters.[7] Two Code provisions account for this discrimination by allowing homeowners to deduct interest on home mortgages[8] and the entire amount of local property taxes.[9] Of all itemized deductions allowable on the individual tax return, these two items are typically the largest.[10] Some economists would add a third discriminatory factor: The failure to tax the imputed net rental value of owner-occupied housing. The following comment is typical of those made by individuals who consider the Code's discriminatory treatment of renters as three-fold:

> The omission of imputed net rent from [adjusted gross income] and the personal deduction for mortgage interest and property taxes discriminate in favor of homeowners compared with renters and with other investors. Homeowners obtain a tax-free return on their investment and at the same time are allowed to deduct important items of housing costs that tenants also pay as part of their rent but without obtaining a tax deduction.[11]

Under the Civil War income tax laws, tenants were allowed to deduct rent,[12] and homeowners were allowed to deduct mortgage interest and property taxes.[13] Congress has not followed this early precedent; no subsequent income tax law has allowed a deduction for rent.[14]

This Note will examine the policies that have resulted in inequitable tax treatment of renters, consider some reforms that have been suggested in the past, and propose a revision of the Code that would provide deductions both for homeowners and renters.

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[7]H. AARON, SHELTER AND SUBSIDIES: WHO BENEFITS FROM FEDERAL HOUSING POLICIES (1972); R. GOODE, THE INDIVIDUAL INCOME TAX 118 (rev. ed. 1976); J. PECHMAN, FEDERAL TAX POLICY 85 (3d ed. 1977); H. SIMONS, PERSONAL INCOME TAXATION 112 (1938); White & White, *supra* note 6.

[8]I.R.C. § 163.

[9]*Id.* § 164(a)(1).

[10]INT. REV. SERV., U.S. DEP'T OF TREAS., STATISTICS OF INCOME—1975, INDIVIDUAL 50-57 (1978).

[11]R. GOODE, *supra* note 7, at 118.

[12]Act of Mar. 3, 1863, ch. 74, § 11, 12 Stat. 713, 723 (1863).

[13]Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223 (1864), *as amended by* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (1865).

[14]The state of Indiana, however, recently enacted a provision, effective Jan. 1, 1979, for the deduction from Indiana income tax of rent paid on a dwelling that is subject to property tax. The maximum deduction is $1,500. Act of Mar. 27, 1979, Pub. L. No. 70 (1979), amending IND. CODE § 6-3-1-3.1. A similar provision was effective for the years 1973 to 1975. Renters were allowed a deduction of up to $1,000 of rent paid. IND. CODE § 6-3-1-3.1 (1976).

II. Itemized Deductions: Some Policy Considerations

The reasons for the exclusion of the rent deduction and the inclusion of the deductions for mortgage interest and taxes under present law are not clear. The current Code provisions for deductions of interest[15] and taxes[16] can be traced to the Tariff Act of 1913.[17] Allowable deductions then included the following: business expenses, but not personal, living, or family expenses; all interest; all taxes except assessments against local benefits; casualty losses; worthless debts; and depreciation of business property.[18] Despite the fact that personal expenses were explicitly excluded, important exceptions were made. The deductions for interest, casualty losses, and worthless debts were not restricted to expenses incurred in the production of income.

The current Code provides for itemized deductions of the following personal expenses: medical expenses in excess of three percent of adjusted gross income;[19] real and personal property taxes, state and local income and sales tax, and gasoline tax;[20] interest;[21] charitable contributions;[22] and casualty and theft losses.[23] Other miscellaneous itemized deductions, such as job-related educational expenses[24] and union dues,[25] are characterized as trade or business expenses[26] rather than personal expenses. Worthless debts may also be deducted, but as an adjustment to income rather than as an itemized deduction.[27] Deductions for personal and living expenses other than those expressly provided for are prohibited.[28]

Various attempts have been made to categorize allowable itemized deductions in order to discover some justification for the inclusion of some personal expenses and not others. It has been suggested that at least some personal expenses, such as medical costs, charitable contributions, and alimony, are based entirely upon the ability to pay.[29] This characterization coincides with Professor Simons' concept of income taxation as an "instrument of economic control, a means of

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[15]I.R.C. § 163.
[16]*Id.* § 164.
[17]Tariff Act of 1913, ch. 16, § II, 38 Stat. 114 (1913).
[18]*Id.*
[19]I.R.C. § 213.
[20]*Id.* § 164(a).
[21]*Id.* § 163.
[22]*Id.* § 170.
[23]*Id.* § 165(c)(3).
[24]Treas. Reg. § 1.162-5 (1960).
[25]*Id.* § 1.162-15.
[26]I.R.C. § 162.
[27]*Id.* § 166(d)(1)(B).
[28]*Id.* § 262.
[29]R. Paul, Taxation for Prosperity 264 (1947).

mitigating economic inequality."[30] Of all our taxes, the income tax with its progressive rates is based most nearly on the ability-to-pay principle. Simons considers the defining of income to be the most serious obstacle to the equitable treatment of all taxpayers.[31] If itemized deductions do serve an "income-defining function,"[32] it is difficult to justify the exclusion of certain large personal expenses, such as college tuition, funeral expenses, commuting costs, and for that matter, the cost of food, clothing, and shelter.[33] While some deductions seem to be based upon the ability to pay, itemized deductions taken as a whole do not, in fact, define income.

There is some support for the idea that deductions are a means of implementing social rather than economic policies; that is, that they are a form of indirect government subsidy.[34] At least one court has recognized that the deduction for charitable contributions constitutes a subsidy:

> We think there is little question that the provision of a tax deduction for charitable contributions is a grant of federal financial assistance within the scope of the 1964 Civil Rights Act.
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> . . . .
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> . . . Unlike the exemption for nonprofit clubs, it cannot be explained simply as a matter of pure tax policy. Since it is available only to particular groups, it operates in fact as a subsidy in favor of the particular activities these groups are pursuing.[35]

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[30]H. SIMONS, *supra* note 7, at 41.

[31]*Id.* at 41-42.

[32]Bittker, *supra* note 5, at 204.

[33]The zero bracket amount (formerly the standard deduction) serves as a floor below which income is not taxed. Presumably, this floor represents an amount of untaxed income for food, clothing, shelter, and other necessities. In 1977 the zero bracket amount for a single person was $2,200. INT. REV. SERV., U.S. DEP'T OF TREAS., YOUR FEDERAL INCOME TAX 6 (1978). Combined with the personal exemption of $750, *id.* at 14, this amounts to $245.83 per month.

[34]*The Economics of Federal Subsidy Programs: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm.*, 92d Cong., 1st Sess. 43 (1972) (statement of Stanley S. Surrey); C. KAHN, PERSONAL DEDUCTIONS IN FEDERAL INCOME TAX (1960); J. PECHMAN, *supra* note 7; Dodyk, *The Tax Reform Act of 1969 and the Poor*, 71 COLUM. L. REV. 758, 780-81; Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). *But see* Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969).

[35]McGlotten v. Connally, 338 F. Supp. 448, 462 (D.D.C. 1972) (class action to enjoin granting of tax benefits to fraternal and nonprofit organizations which exclude nonwhites).

As Secretary of the Department of Housing and Urban Development,[36] George Romney publicly noted that deductions are, in effect, subsidies: "Maybe we ought to repeal part of the right to deduct the interest rate from the income tax return to bring home to middle income and affluent families that they are getting a housing subsidy."[37] If homeowner deductions are a subsidy, the size of the subsidy is substantial. Professor Surrey has emphasized the magnitude of this indirect subsidy by comparing its cost with the cost of direct government subsidies:

> The tax expenditure items for housing—deductions for mortgage interest and property taxes—constitute the largest items in the Government program to assist private housing, far in excess of direct expenditure programs in the housing area. Thus, for 1970, these tax expenditures came to $5.4 billion, and the direct expenditures came to $2.7 billion.[38]

It cannot be said that Congress consciously devised ways of assisting the homeowner at the expense of the renter. The deductions for interest and taxes are general provisions. The interest deduction applies not only to mortgage interest but also to interest on all consumer purchases and investment indebtedness. Deductions for taxes were probably allowed originally as a method of avoiding double taxation. In the original Act of 1913,[39] all taxes were deductible. The deduction of the federal income tax was eliminated in 1917[40] and the deduction for federal excise taxes in 1943.[41] In 1964, deductible taxes were enumerated for the first time.[42] Recognizing that state and local income, property, and sales taxes are the major sources of revenue for state and local governments, Congress continued the deduction of these taxes, not only to ease the burden of multiple taxation but also to allow the federal government to remain properly neutral as to the relative use of these taxes.[43]

It would have been commendable if Congress had also remained neutral on the question of renting or buying a shelter. The House

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[36]Secretary Romney assumed office Jan. 22, 1969, and resigned Nov. 22, 1972. BIOGRAPHICAL DIRECTORY OF THE UNITED STATES EXECUTIVE BRANCH 1774-1977, at 290-91 (R. Sobel ed. 1977).

[37]N.Y. Times, Oct. 24, 1969, at 18, col. 5.

[38]S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 235 (1973).

[39]Tariff Act of 1913, ch. 16, § 11, 38 Stat. 114 (1913).

[40]War Revenue Act, ch. 63, § 1201, 40 Stat. 300 (1917).

[41]Revenue Act of 1943, ch. 63, § 111, 58 Stat. 21 (1944).

[42]Revenue Act of 1964, Pub. L. No. 88-272, § 207, 78 Stat. 19 (1964).

[43]H.R. REP. NO. 749, 88th Cong., 2d Sess., *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1313, 1357.

report contains this rather cryptic statement on the advisability of continuing the deduction for property taxes: "The burden of property taxes varies widely among individuals according to whether or not they are homeowners. Thus, any denial of deductions in such cases would result in an important shift in the distribution of Federal income taxes between homeowners and non-homeowners."[44]

The general provisions for interest and tax deductions have now been adopted retrospectively as one method of achieving the government's goal "to expand homeownership opportunities to as broad a segment of our society as can reasonably afford it . . . ."[45] As a national goal, the fostering of home ownership may be desirable. However, this policy does not consider a large segment of the population—those who, out of choice or necessity, live in rental housing.[46]

III. An Analysis of Some Suggested Reforms

Several remedies have been offered to eliminate the inequities of the present Code. The most popular is the inclusion in income of the imputed net rental value of owner-occupied housing.[47] The homeowner would report as income the gross imputed rent on his residence and then deduct repairs, taxes, interest, depreciation, and other expenses. Although the taxation of imputed rent may seem a novel idea in the United States,[48] it has been employed in many foreign countries.[49] Advocates of this plan stress its obvious fairness in terms of equalizing the tax burden imposed on renters and homeowners. Richard Goode of the Brookings Institution has stated that taxing imputed rent is the *only* way to eliminate tax discrimination between homeowners and persons who choose some other form of investment.[50] The Commission to Revise the Tax Structure noted

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[44]*Id.*

[45]Ninth Annual Report on the National Housing Goal, H.R. Doc. No. 95-53, 95th Cong., 1st Sess. 5 (1977).

[46]In 1975, 25,656,000 (35.4%) of the 72,523,000 housing units in the United States were renter-occupied. U.S. Dep't of Housing and Urban Development, Statistical Yearbook 264 (1975).

[47]H. Aaron, *supra* note 7, at 71; R. Goode, *supra* note 7, at 123-24; H. Simons, *supra* note 7, at 112.

[48]It is interesting that taxation of rental value was specifically *excluded* by the Civil War income tax provisions: "[T]he rental value of any homestead used or occupied by any person or by his family . . . shall not be included and assessed as part of the income of such person." Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223, 281 (1864).

[49]Great Britain terminated the program in 1963. For a brief overview of taxation of imputed rent by foreign countries, see Merz, *Foreign Income Tax Treatment of the Imputed Rental Value of Owner-Occupied Housing: Synopsis and Commentary*, 30 Nat'l Tax J. 435 (1977).

[50]R. Goode, *supra* note 7.

that this revision would place the federal government in an appropriately neutral position regarding the decision by the individual taxpayer to own or rent his dwelling.[51]

One objection to this solution, acknowledged by some of its advocates, is that it poses serious administrative problems.[52] For example, establishment of guidelines for computing imputed rent would be difficult. Several methods have been suggested: a percentage of the owner's equity (market value less debt),[53] gross rental value less cost;[54] and direct estimation by the owner.[55] None of the proposed methods is without disadvantages; each implies a standard upon which rental or market value would be based. The use of the assessed valuation for property tax purposes would be unworkable due to the discrepancies in taxing policy and procedure among local taxing jurisdictions.[56] On the other hand, if the homeowner had to estimate market or rental value based upon his general knowledge of market conditions, the kind of documentation needed to substantiate the estimate is unclear. To avoid this and similar problems, some type of uniform system of value assessment would be necessary, either a system of federal evaluation of residential property, or a federally mandated uniform local system.

Another serious consideration is the cost of administering such a tax program compared to the increased revenue yield. In a 1969 study based on a Brookings Institution sample of 100,000 individual income tax returns filed for 1964, Robert Tinney estimated an increased revenue yield of between $6,062 and $6,719 million.[57] However, he did not take into account the cost of establishing a valuation system, and data is lacking for the projection of such cost. Many foreign countries which taxed imputed rental value in the past have abandoned the program.[58] One author has suggested that the reason is the low revenue yield:

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[51]COMMISSION TO REVISE THE TAX STRUCTURE, REFORMING THE FEDERAL TAX STRUCTURE 18 (1973).

[52]H. AARON, *supra* note 7, at 71; R. GOODE, *supra* note 7, at 124.

[53]*The Economics of Federal Subsidy Programs: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Committee*, 92d Cong., 1st Sess. 43, 96 (1972) (joint statement of Joseph A. Pechman & Benjamin Okner) [hereinafter cited as *The Economics of Federal Subsidy Programs*]; R. GOODE, *supra* note 7, at 124.

[54]*The Economics of Federal Subsidy Programs*, *supra* note 53.

[55]R. GOODE, *supra* note 7, at 124.

[56]*See* Note, *Inequality in Property Tax Assessments: New Cures for an Old Ill*, 75 HARV. L. REV. 1374 (1962).

[57]Tinney, *Taxing Imputed Rental Income on Owner-occupied Homes*, in STUDIES IN SUBSTANTIVE TAX REFORM 125 (A. Willis ed. 1969).

[58]Merz, *supra* note 49, at 435. In his book on personal income tax published in 1938, Henry Simons commented that the United States and Canada were the only important countries *not* taxing imputed rent. H. SIMONS, *supra* note 7, at 112 n.3.

> Overall, the experiences with attempts to tax this form of personal income have a distressing similarity, viz., taxes on this form of income have produced (or do produce) negligible amounts of revenue relative to the yield of personal income taxes in general and the administration and enforcement of income taxes on imputed rental income have been and remain a matter of great vexation to the tax authorities.
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> Abnormally low estimates of rental value, either as a product of administrative practice and tradition or as a consequence of statutory enactments setting nominal valuations or freezing valuations for long periods of time are common. Rising costs which may be used to offset this income, particularly mortgage interest, seriously erode the amount of this form of income subject to tax. A negative net value for imputed rent for owners with large mortgages is not uncommon, excess interest in this instance being carried over as an offset to other income.[59]

It has been argued that the taxation of imputed rent can be defended, even if the cost of administration exceeds the revenue, because it is equitable.[60] This view can be adopted only if income taxation is considered exclusively as a means of achieving economic justice, and not as a means of obtaining revenue.

Even if taxation of this form of income were adopted, it is doubtful whether it could withstand a challenge in the courts. The Supreme Court has defined income as gain derived from capital and from labor.[61] It has also specifically held that the rental value of a building is not income within the meaning of the sixteenth amendment.[62]

It is also doubtful that taxation of imputed rent would be acceptable in the United States even apart from the legal issues that could be raised. To suggest such a plan may well be, in Henry Aaron's phrase, "politically unthinkable."[63] Homeowners are accustomed to looking upon their homes as a source of expense rather than income. Furthermore, if the value of housing is to be taxed, why not the value of other durable consumer goods, such as automobiles and appliances? The exchange of one form of tax discrimination for another would be neither fair nor politically acceptable. Finally, this form of taxation would have the unpopular ef-

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[59]Merz, *supra* note 49, at 435-37.

[60]H. SIMMONS, *supra* note 7, at 30-31.

[61]Eisner v. Macomber, 252 U.S. 189, 207 (1920).

[62]Helvering v. Independent Life Ins. Co., 292 U.S. 371, 379 (1934).

[63]H. AARON, *supra* note 7, at 71.

fect of increasing the tax base and further complicating the individual income tax return.

Another feasible solution to the present inequities in the tax treatment of homeowners and renters is disallowance of the mortgage interest and property tax deductions presently available to homeowners. Most proponents of this plan consider it a halfway measure, not as meritorious as taxing imputed rent, but better than no solution at all.[64] Homeowners and renters would be taxed more evenly than at present, and, in this case, no valuation or administrative problems would arise.

There are, however, both economic and equitable problems with this proposal. One economic consequence is the possible effect on lending institutions, a consideration which has led one economist to comment:

> If deductions for mortgage interest were disallowed, homeowners would be encouraged to borrow on assets other than their homes. To the extent that they could substitute other credit instruments, disallowance of deductions for mortgage interest would have no tax consequences. The impact would be massive on markets for financial assets, however. For financial intermediaries, such as savings and loan associatons, which are restricted by law to investing in home mortgages, the result wold be catastrophic.[65]

Following this line of reasoning and assuming that taxing policies influence the consumer's decision of whether to buy or rent a home, one can foresee a recession in the home building industries the effects of which would be felt throughout the economy.[66]

The disallowance of the property tax deduction could cause serious repercussions in those local areas that depend heavily upon revenue from property tax. Moreover, in view of Congress' interest in remaining neutral as to the choice of taxes upon which local governments depend,[67] there is no justification for disallowing the

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[64]Those who advocate taxation of imputed rent obviously consider this an incomplete solution. *E.g.*, R. GOODE, *supra* note 7, at 124 (stating: "The elimination of the interest deduction, for example, would have no effect on persons who own their dwellings free of mortgage debt and hence would do nothing to reduce the discrimination between this group and tenants.").

[65]H. AARON, *supra* note 7, at 72.

[66]The effect would not be limited to owner-occupied housing. For owners of rental property, the result would be equally severe. Property taxes are typically the largest expenditure, next to loan payments, by owners of income producing property. U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, STUDY ON TAX CONSIDERATIONS IN MULTI-FAMILY HOUSING INVESTMENTS 106 (1972).

[67]H.R. REP. NO. 749, *supra* note 43.

property tax deduction while continuing the deductions for local income and sales taxes.

Similarly, the disallowance of the mortgage interest deduction cannot be justified without disallowance of all interest deductions except for interest expenses incurred in the production of income. This in turn raises the problem of defining income-producing debts. Because it is not uncommon to borrow on personal assets to finance a business venture, one would have to ascertain the *motive* of the borrower in order to separate deductible from nondeductible interest.

The two proposals just considered, the taxation of imputed rent and the elimination of the homeowner's deductions, attack the problem of discriminatory taxation by taking away from the homeowner what presently amounts to favorable tax treatment. Equity, however, can be achieved without these drastic measures and the problems which attend them. There are at least two devices for granting tax relief to renters *without* depriving the homeowner of tax concessions traditionally granted him—the tax credit and the itemized deduction.

A tax credit, unlike a deduction, offers tax relief equally to taxpayers in all income brackets. It is a direct subtraction from taxes computed for the taxable year. Tax credits against federal income tax have been suggested as a means of relief from rising local property taxes.[68] "Circuit-breaker" provisions that offer income tax relief for property taxes paid, often in the form of a refundable credit, have been enacted in many states,[69] including Indiana.[70] Many of the circuit-breaker systems offer relief to renters as well, basing the credit on that portion of rental payments attributable to property taxes.[71] This distinctive feature of the circuit-breaker may be one

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[68]*E.g.*, Senate Amend. No. 98, 92nd Cong., 1st Sess., 117 CONG. REC. 42509-15 (1971) (credit for elderly renters adopted by Senate in 1971 Revenue Act, rejected in Conference Committee).

[69]ARIZ. REV. STAT. ANN. § 43.128.01 (Supp. 1978); ARK. STAT. ANN. § 84-2021.10 (Supp. 1975); COLO. REV. STAT. § 39-22-120 (1973); D.C. CODE ENCYCL. § 47-1567g (West Supp. 1978); MICH. COMP. LAWS §§ 206.501-522 (Supp. 1978); MINN. STAT. ANN. §§ 290A.03-04 (West 1978); MO. REV. STAT. §§ 135.010-030 (1979); N.M. STAT. ANN. § 7-2-18 (1978); N.Y. TAX LAW §§ 606, 612 (McKinney Supp. 1977); OKLA. STAT. ANN. tit. 68, §§ 5001-09 (West 1978); R.I. GEN. LAWS § 44-33-9 (1978); VT. STAT. ANN. tit. 32, §§ 5961, 67 (Supp. 1978); WIS. STAT. ANN. § 71.09(7) (West 1969 & Supp. 1978-79). Illinois provides a grant rather than a tax credit. ILL. ANN. STAT. ch. 67½, § 404 (Smith-Hurd Supp. 1978). Three states offer a tax credit for renters only. CAL. REV. & TAX. CODE § 17053.5 (West 1979); HAW. REV. STAT. § 235-55.7 (1978); N.J. STAT. ANN. § 54A:4-3 (West 1978).

[70]IND. CODE § 6-3-3-6 (1976).

[71]*See* the circuit-breaker provisions for Arizona, Colorado, District of Columbia, Indiana, Michigan, Minnesota, Missouri, New Mexico, New York, Rhode Island, Vermont, and Wisconsin in notes 69 & 70 *supra*.

reason for its increasing popularity. In a feasibility study of circuit-breaker systems prior to the enactment of the Indiana circuit-breaker, the Director of the Indiana Commission on State Tax and Financing Policy stated:

> [T]he property tax circuit-breaker . . . has the unique advantage of being able to directly grant relief to renters. If the general level of property tax rates declines, relief does not immediately go to renters. At best, over a period of years competition will force rents to decline, or rise slower than otherwise, to reflect the lower property taxes paid by the landlord. But if the market is not very competitive even this will not occur; rather, the landlord receives a permanent windfall.[72]

The Indiana circuit-breaker, enacted in 1973, is typical. The statute allows a refundable credit to homeowners and renters who are either over sixty-five or disabled, and have an annual income of less than $5,000.[73] The amount of the credit is determined by household income and ranges from ten to seventy-five percent of property taxes paid, the maximum credit allowable being $375.[74] For renters, the credit is based upon that portion of the rent constituting property taxes, calculated at twenty percent of gross rent paid.[75]

Most states which have enacted circuit-breaker legislation limit the credit to families with low incomes; however, in some states the maximum income limitation is considerably higher than in Indiana.[76] In addition, several states limit the tax credit to those who are either over sixty-five or disabled.[77]

A federal tax credit could be modeled after the state circuit-breakers and expanded to include all who pay property taxes directly, or indirectly in the form of rent. If Congress wished to retain the circuit-breaker concept, the percentage of credit could be based upon a graduated income scale, as in the Indiana plan. A credit of this kind would benefit primarily those in the lower income brackets, but it would offer some relief to those in the middle income brackets if the income ceiling were high enough.

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[72]D. KIEFER, THE EFFECTS OF A PROPERTY TAX CIRCUIT-BREAKER IN INDIANA 10 (1972).

[73]IND. CODE § 6-3-3-6 (1976).

[74]*Id.*

[75]*Id.*

[76]The income limitation is $12,000 in New York, 1978 N.Y. LAWS §§ 606, 612, and $20,000 in the District of Columbia, D.C. CODE ENCYCL. § 47-1567g (West Supp. 1977).

[77]Arizona, Arkansas, Missouri, New Mexico, and Rhode Island offer the credit to the elderly only. Colorado, Michigan, and Oklahoma offer the credit to both the elderly and disabled. *See* the circuit-breaker statutes contained in note 69 *supra*.

A tax credit based upon the property tax burden is an incomplete solution, of course. It offers no relief to renters for that portion of the rent representing mortgage interest.

Of all the proposed solutions to the problem of tax discrimination against renters, the simplest is the deduction of rent payments for homesteads, essentially a re-enactment of the Civil War income tax provision previously mentioned.[78] The greatest virtue of the rent deduction, next to its simplicity, is that it is an ability-to-pay deduction; that is, a necessary expenditure that effectively reduces real income. However, if one wishes to adhere to the principle that deductions should serve to define income,[79] there is little justification for allowing a deduction for rent and excluding deductions for other necessary personal expenses. Persuasive arguments can be made for the idea that itemized deductions should be limited to essential expenses such as food, clothing, shelter, and medical costs, and, perhaps, to socially valuable expenditures such as charitable and political contributions. However, a tax reform of this magnitude, which might introduce into the taxying system a hitherto uncontemplated complexity, is outside the scope of this Note. As a solution to unfair taxing policies, a deduction for rent has little merit since it would simply reverse the discrimination which presently exists. Total rent equals more than the sum of interest and taxes now deductible by homeowners.

Perhaps the most logical answer to the problem of unequal taxation of homeowners and renters is to allow the deduction of that portion of rent constituting property taxes and mortgage interest. This proposed deduction would be relatively simple to administer, and it would all but eliminate the tax inequities between homeowners and renters without depriving the homeowner of the tax benefits he presently enjoys.[80] This proposal would, of course, require a revision of the current law, beginning with sections 163[81] and 164[82] of the Internal Revenue Code.

IV. Current Status of the Law

Section 164 of the Code provides that real property taxes shall be allowed as a deduction for the taxable year in which they are paid or or accrued. The Treasury Department and the courts have

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[78]*See* note 1 *supra.*

[79]*See* notes 29 & 30 *supra.*

[80]The homeowner would retain the benefit of capital gain treatment upon sale of his residence. I.R.C. § 1202.

[81]This section states in part: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

[82]This section provides for the deduction of taxes "paid or accrued" within the taxable year. For a list of deductible taxes, see text accompanying note 20 *supra.*

interpreted this provision to mean that taxes are deductible only by the person upon whom they are *imposed.*[83] In *Peters v. Commissioner*[84] a property owner whose taxes were paid by a third party was allowed to take the deduction.[85] Thus, actual payment of the tax was not a prerequisite to deductibility. The court in *Peters* stated:

> There [are] no specified statutory requirements that the payment of taxes be an out-of-pocket expenditure of, or directly attributable to, the property owner seeking the benefit of the deduction. . . . Regardless of whether satisfaction of petitioner's obligation is income, a gift, a loan, or repayment of a loan, at least to the extent that it satisfies his obligation it should be deductible by him.[86]

In *Harris v. Commissioner*[87] an owner of mortgaged property was allowed to deduct real estate taxes and interest voluntarily paid by the mortgagee before foreclosing the mortgage.[88] A deduction has been allowed to the mortgagor for mortgage assistance payments made by the Department of Housing and Urban Development to the extent that the payments were for real estate taxes, even though the payments were not income to the mortgagor.[89] The Internal Revenue Service has also ruled that a minister may deduct interest and taxes paid on his personal residence despite the fact that he is entitled to a rental allowance under section 107.[90]

When property taxes are paid by the tenant under the terms of a lease, the landlord takes the deduction. Two lines of reasoning support this result. One is that payments by the tenant to the landlord, even if labelled as a contribution to taxes, are payments for the privilege of occupying the premises and therefore are rent.[91] The other theory is that, even if the lease obligates the tenant to pay the property taxes, the obligation is to the landlord and not to the governmental body imposing the tax.[92] Thus, tax increases paid

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[83]Gilken Corp. v. Commissioner, 176 F.2d 141, 143 (6th Cir. 1949); Willamette Valley Lumber Co. v. United States, 252 F. Supp. 199, 203 (D. Ore. 1966); Treas. Reg. § 1.164-1 (1957).

[84]29 T.C.M. (CCH) 1440 (1970).

[85]*Id.* at 1442.

[86]*Id.*

[87]34 T.C.M. (CCH) 597 (1975).

[88]*Id.* at 600.

[89]Letter from the Internal Revenue Service, Dep't of Treasury, to Mortgage Bankers Association of America (Dec. 10, 1969).

[90]Rev. Rul. 62-212, 1962-2 C.B. 41.

[91]*See* W.T. Grant Co. v. Commissioner, 129 Conn. 663, 666, 30 A.2d 921, 922-23 (1943); Vineland Shopping Center, Inc. v. DeMarco, 35 N.J. 459, 470, 173 A.2d 270, 276 (1961).

[92]*See* Robinson v. Commissioner, 53 F.2d 810, 811 (8th Cir. 1931); W.T. Grant Co. v. Commissioner, 129 Conn. 663, 667, 30 A.2d 921, 923 (1943).

directly by the tenant in the form of a tax surcharge are deductible by the landlord and not the tenant.[93] The Internal Revenue Service stated its position as follows:

> The city ordinance, which permits the landlord to pass on increases in such taxes to a tenant in the form of a surcharge, does not shift liability for the property taxes from the landlord to the tenant. The surcharge is simply, for Federal income tax purposes, an additional rental payment by the tenant.[94]

Similarly, taxes designated as "renters" tax[95] or "rates"[96] tax that are assessed against the renter and based upon the rental value of the dwelling are not deductible. In a 1973 revenue ruling, a United States citizen living in the United Kingdom was not permitted to deduct a local tax based on the rental value of the rented premises.[97] The ruling stated that the tax was not deductible as a foreign property tax under section 164(a)(1) of the Code because it was a tax levied on the occupation or use of, rather than on an interest in, real property.[98] In a later ruling, a tax levied by Prince George's County, Maryland, based upon a percentage of rent paid, was held to be not deductible for the reason that the tax was based upon occupancy rather than ownership of the property, for which tax there is only personal liability.[99]

The rule that taxes are deductible only by the one upon whom they are imposed is perhaps best illustrated by the provision of the Code that requires apportionment of taxes between buyer and seller if the sales transaction occurs in the middle of the taxable year.[100] The tax allocable to that part of the year ending on the day before the sale is treated as imposed upon the seller, whereas the tax allocable to the part of the year beginning on the date of sale is treated as imposed upon the buyer. This provision does not require an actual proration insofar as the payment of the tax is concerned. The buyer gets an automatic deduction of the tax allocable to him, regardless of whether he or the seller paid the tax.[101]

Construction of section 163[102] has also been quite restrictive. For interest to be deductible, three factors are essential: (1) In-

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[93]Rev. Rul. 75-301, 1975-2 C.B. 66.

[94]*Id.*

[95]Rev. Rul. 75-558, 1975-2 C.B. 67.

[96]Rev. Rul. 73-600, 1973-2 C.B. 47.

[97]*Id.* at 49.

[98]*Id.* at 48-49.

[99]Rev. Rul. 75-558, 1975-2 C.B. at 68.

[100]I.R.C. § 164(d).

[101]Cramer v. Commissioner, 55 T.C. 1125, 1131 (1971).

[102]*See* note 81 *supra.*

debtedness, (2) interest on indebtedness, and (3) the payment or accrual of interest within the tax year.[103] Indebtedness has been defined as "something owed in money which one is unconditionally obligated or bound to pay, the payment of which is enforceable."[104] Furthermore, the interest must be specifically and separately stated. One court refused to imply an obligation to pay interest from an agreement merely to pay an agreed price in installments due at a future date.[105]

From the foregoing discussion it can be concluded that in order for tax on real property to be deductible it must be: (1) Imposed on the property at issue, and (2) imposed on the legal owner. In addition, deductible interest apparently must be on an actual indebtedness owed by the person taking the deduction. In some instances, however, these requirements have been waived, either by statute or by court decisions.

In *Offutt Housing Co. v. County of Sarpy*,[106] the Supreme Court held that a lessee was subject to state property taxes on improvements erected by the lessee on land leased from the federal government.[107] This decision has not been broadly applied due to the very particular and atypical facts giving rise to the ligitation: The improvements had a useful life of thirty-five years while the lease ran for seventy-five years, the lessee paid only nominal rent for the land, and the lessee was required by the terms of the lease to pay all state and local property taxes. The court held that, although the government had title to the land, it was only a "paper title" and lessee's interest in the improvements encompassed the entire worth of the improvements.[108] By implication the decision entitles the lessee upon whom the property taxes are imposed to deduct the amount of taxes paid from income. The Internal Revenue Service, however, has carefully limited the *Offutt* precedent to permit deduction of property taxes paid by the lessee only in cases in which the lessee is entitled to the sole enjoyment of the entire interest in the improvements.[109]

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[103]Tomlinson v. 1661 Corp., 377 F.2d 291, 295 (5th Cir. 1967); *accord*, United States v. Norton, 250 F.2d 902, 905 (5th Cir. 1958).

[104]Commissioner v. Wilson, 163 F.2d 680, 682 (9th Cir. 1947).

[105]Daniel Bros. Co. v. Commissioner, 28 F.2d 761 (5th Cir. 1928).

[106]351 U.S. 253 (1956).

[107]*Id.* at 262.

[108]*Id.* at 261-62.

[109]*See, e.g.*, Rev. Rul. 62-177, 1962-2 C.B. 89. The Internal Revenue Service refused to allow a deduction for real estate taxes to a corporation that had leased land with an existing building, the useful life of which was shorter than the term of the lease. The ruling stated that the lessee was not entitled to the sole enjoyment of the improvements since the lessor received a substantial benefit in the form of rent. Payment of taxes by the lessee corporation was deemed to be the equivalent of rent. *Id.*

Under the Code, taxes, interest, and depreciation deductible by cooperative housing corporations are passed through to the tenant-shareholder, each deducting his proportionate share according to the number of shares he owns.[110] If the criteria set out in *Offutt* are met, these deductions may be taken even though the corporation leases rather than owns the building in which the tenant resides. This was demonstrated by a situation in which a corporation leased land and constructed thereon an apartment building with an estimated useful life shorter than the term of the lease.[111] Even though legal title to the building was vested in the lessor, real estate taxes paid on the building and interest paid to finance construction were deductible to the corporation, and thus also to the tenant-shareholder.[112]

In other instances the possession of legal title to the property has not been a prerequisite to deduction of property taxes. An owner of a beneficial interest may, in some cases, qualify for the deduction. In one case, a taxpayer who conveyed property subject to a reserved term of five years for his own use and possession and also subject to an agreement that he would pay the taxes during the reserved term was allowed to deduct the taxes paid.[113] The tax court has also allowed beneficiaries of trusts to deduct property taxes assessed to the trustee because payment by the beneficiary was necessary to protect the beneficial interest.[114]

The foregoing examples are illustrative of two related propositions, either of which would provide rational support for the proposal that renters should be allowed to deduct interest and taxes. The first proposition is that in many cases the entity against whom taxes are imposed, or against whom interest is charged, is a mere

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[110]I.R.C. § 216.

[111]Rev. Rul. 62-178, 1962-2 C.B. 91.

[112]*Id.*

[113]Rev. Rul. 67-21, 1967-1 C.B. 45.

[114]Estate of Movius v. Commissioner, 22 T.C. 391 (1954) (holding taxes assessed on properties of the estate and paid by the trustees from funds designated by the beneficiaries for that purpose to be the equivalent of payment by the beneficiaries); Horsford v. Commissioner, 2 T.C. 826 (1943) (determining that taxpayer holding property in trust was required by the will to pay all taxes even though taxes were assessed to the trustee); *cf.* Harrison v. Commissioner, 17 T.C. 1350 (1952) (holding that in computing gift tax, donor may exclude from the value of the gift the gift taxes paid by the trustee); Gruen v. Commissioner, 1 T.C. 130 (1942) (holding that because donor was insolvent at the time of the transfer and the income tax liability shifted to the donees, the value of the gifts was decreased by the income tax paid by donees as transferees of the donor); Rev. Rul. 75-72, 1975-1 C.B. 310 (advising that if a gift is made subject to the condition that the gift tax be paid by the donee, the tax is deducted from the value of the gift in computing donor's gift tax). *See also* Corliss v. Bowers, 281 U.S. 376 (1930) (holding income from trust taxable to taxpayer who retained power over the funds, on the theory that taxation is concerned less with refinements of title than with command over the property and the benefit for whom the tax is paid).

conduit through which the deductible expenses flow. Whether the conduit is a corporation,[115] a trust,[116] or a landlord, the one in possession of the property has actually borne the expense. The following analysis by economist Henry Aaron explains that, sooner or later, the renter pays the property tax:

> [U]sers of real property eventually must pay property taxes on structures through higher sales prices or rents . . . . After sufficient time, an increase in property taxes will shrink the stock of structures and force up their rental prices. . . . A rise in taxes would initially fall on owners, reducing their net income. Either of two sets of events might ensue. In the first, owners, now denied their former rates of return on investment in structures, may curtail investment in new structures, rehabilitation, and maintenance. As a result, the stock of structures will become less valuable than the stock that would have prevailed in the absence of the tax; and users will pay higher rents for the restricted stock. This process will continue until the rental income per dollar of new construction, *net of tax*, is as high as it was before taxes were increased. Rents will therefore be increased by the amount of tax. Alternatively, owners may short-circuit this process by raising rents directly when taxes increase. This course is more likely if demand for structures is rising independently—for example, because of population growth. . . . The end result is the same as in the first case.[117]

In the same way, any fluctuation in the interest rate will be reflected, in the short or long run, in prices and rents.

The second proposition is that the one who bears the expense should receive the tax benefit. This principle was apparently recognized by Congress in 1864 when it amended the income tax statutes to provide for the deduction of taxes by the one who paid them,[118] and more recently by the tax court in allowing a deduction for taxes by the beneficial owner.[119] Since principles of equity have in some instances prevailed over technical construction of the Code, there is at least some precedent for the idea that those who actually

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[115]I.R.C. § 216.

[116]Estate of Movius v. Commissioner, 22 T.C. 391 (1954); Horsford v. Commissioner, 2 T.C. 826 (1943).

[117]H. AARON, WHO PAYS THE PROPERTY TAX? 24 (1975).

[118]"[N]ational, state, and local taxes, lawfully assessed upon the property or other sources of income of any persons . . . shall be first deducted from the gains, profits, or income of the person or persons who actually pay the same, whether owner or tenant . . . ." Act of July 1, 1862, ch. 119, § 91, 12 Stat. 432, 473-74 (1862).

[119]Estate of Movius v. Commissioner, 22 T.C. 391, 394-95 (1954); Horsford v. Commissioner, 2 T.C. 826 (1943).

bear the expense of deductible items, even though indirectly in the form of rent, should be allowed the deduction.

V. The Proposed Deduction for Renters

The relative simplicity of the renters' deduction; has already been mentioned. It would merely require a revision of Code sections 163 and 164, and the corresponding regulations, to include the deduction of that portion of rent constituting property taxes and mortgage interest. It would require no major overhaul of the existing tax structure. Unlike the taxation of imputed rent, or the disallowance of the interest and tax deductions for homeowners, there would be no appreciable economic repercussions. In addition, this proposal is more likely to be accepted politically.

As a practical matter, the amount of the deduction should be a flat percentage of rent paid. To require each landlord to keep records of the actual deductible expenses for each rental unit and dissemniate this information to each tenant would be unwieldly and probably unworkable.[120] The flat percentage method is used uniformly by those states that have enacted tax credits for renters, the amount of rent constituting property tax ranging from six to twenty-five percent.[121]

There are, of course, a great variety of methods for arriving at a fair percentage of deductible rent. The simplest method is the use of medians and averages. For example, the average monthly payment of real estate taxes by homeowners in 1976 was $47.[122] The median monthly rent paid in 1975 was $150.[123] Assuming that those who rent paid the same taxes indirectly via the landlord, 30.5% of rent represented property taxes. Since the average mortgage interest rate on new houses in 1975 was 9.01%,[124] it is a safe assumption that at least 40% of rent payments represent the renter's share of real

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[120]Similar objections were made during hearings on the Revenue Act of 1913, which provided for collection of income tax at the source. A lessor or mortgagee was faced with the prospect of turning over to the lessee or mortgagor a statement of annual profits and income as well as an accounting of all deductions and expenses, thus "disclosing his entire private business to his debtors." *Hearings on the Revenue Act of 1913 Before the House Committee on Finance*, 63d Cong., 1st Sess. 1959-61 (1913) (statement by Mass. Real Estate Exchange).

[121]New York allows a credit based upon 25% of rent paid. N.Y. Tax Law §§ 606, 612 (McKinney Supp. 1978). New Mexico allows six percent. N.M. Stat. Ann. § 7-2-18 (1978).

[122]Bureau of the Census, U.S. Dep't of Commerce, Statistical Abstract of the United States 790 (98th annual ed. 1977).

[123]*Id.* at 779. Statistics on the median monthly rent for 1976 are not yet available, since the statistics are only compiled at five-year intervals.

[124]U.S. Dep't of Housing and Urban Development, 1976 Statistical Yearbook 238 (1977).

estate taxes and mortgage interest.[125] Allowing a deduction from income of 40% of rent paid would go far toward equalizing the tax burden of homeowners and renters.

One argument against the percentage-of-rent deduction is that it does not accurately reflect the actual property tax expense since the rate varies widely throughout the country, nor does it reflect actual interest expenses. An alternative method is to tie the property tax deduction to the current local rate, with the percentage changing as property taxes rise and fall. The corresponding interest deduction could be based on the current prime interest rate, or an average bank interest rate for the taxable year. However, the introduction of so many variables into the computation of the deductions would likely result in a complexity that would far outweigh the advantages. If a flat percentage is used, Congress could periodically adjust the percentage to reflect current average interest and property tax rates.

Another objection likely to be raised is that this proposal calls for a double deduction, with both landlord and tenant being entitled to the same deduction. The concept of a double deduction did not, however, preclude the enactment of the rent deduction during the Civil War.[126] The landlord's right to deduct property tax on the rental homestead was not affected.[127] Moreover, a similar situation already exists under the current law. Under the tenant-stockholder provision of the Code, the corporation and the individual tenant deduct the same expenses.[128]

VI. Conclusion

Despite the fact that there may be objections to the idea of a double deduction, the renters' deduction seems to be the best possible solution to the tax inequities between homeowners and renters. It can be justified in light of the suggested rationale for deductions generally as a means of defining income.[129] Also, with the virtual

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[125]Mortgage interest is normally computed on the unpaid balance. The interest rate on new or recent mortgages is currently much higher than 9% per annum. The 40% figure constitutes a compromise between those who pay a higher interest rate and those whose dwelling is not subject to a mortgage.

[126]Act of Mar. 3, 1863, ch. 74, § 11, 12 Stat. 713, 723 (1863).

[127]Act of June 30, 1864, ch. 173, § 117, 13 Stat. 223 (1864), *as amended by* Act of Mar. 3, 1865, ch. 78, 13 Stat. 469 (1865). Neither is the landlord's deduction affected by state circuit breakers.

[128]*See* notes 110-12 *supra* and accompanying text. Rep. Edward I. Koch made this argument when he introduced a bill in Congress to allow renters to deduct that portion of rent attributable to interest and taxes. *General Tax Reform: Public Hearings Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 6817, 6818 (1973) (statement of Hon. Edward I. Koch).

[129]*See* notes 29-33 *supra* and accompanying text.

elimination of differences in the tax consequences of owning or renting a shelter,[130] the government would have assumed a neutral position and the individual could make his choice based on other, more pertinent, considerations.

Finally, this deduction would benefit a large group of taxpayers in the lower-middle and middle income ranges. In 1963, a family with a minimum annual income of $6,820, or 44.3% of all American families, could afford to buy a new median-priced house.[131] In 1975, a minimum of $19,250 annual income was required and the percentage of families in this group had fallen to 31.5%.[132] Of those families with an annual income in 1975 of $25,000 or more, only about 12% live in rental housing, compared to approximately 35% of those in the $10,000 to $15,000 bracket, and 51% of those in the $3,000 to $5,000 bracket.[133] The renters' deduction would have little effect on the last group since very few itemize deductions.[134] As is true of any deduction, the benefit rises with the income. In 1976, 11% of those with an annual income of between $5,000 and $10,000 filed returns claiming deductions for mortgage interest and property taxes, compared with 32% of those in the $10,000 to $15,000 bracket, and 44% of those in the $15,000 to $20,000 bracket.[135] The average tax savings for all returns itemizing these deductions was $391.[136] Obviously, the percentage of those in the lower and middle income brackets who were able to lower their taxable income by itemizing deductions would be much larger if renters were included.

If the cost of housing continues to rise, it is especially important not only that homeowners continue to deduct a portion of their housing costs, but also that renters be allowed similar deductions. Although it has been held that "perfect equality or absolute logical consistency between persons subject to the Internal Revenue Code has [not] been, at least since the adoption of the sixteenth amendment, a constitutional *sine qua non*,"[137] any legislative change aimed in the direction of equality and consistency is surely desirable.

JOAN RUHTENBERG

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[130]*See* note 80 *supra*.

[131]U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, 1976 STATISTICAL YEARBOOK 238 (1977).

[132]*Id.*

[133]*Id.* at 264.

[134]Less than one percent of those in the $3,000 to $5,000 income bracket itemized deductions in 1975. INT. REV. SERVICE, U.S. DEP'T OF TREAS., STATISTICS OF INCOME 16 (1975).

[135]U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, *supra* note 131, at 233.

[136]*Id.*

[137]Barter v. United States, 550 F.2d 1239, 1240 (7th Cir. 1977) (appeal of an adverse judgment in a tax refund suit wherein plaintiffs unsuccessfully contended that the tax rate schedules violated the due process clause of the fifth amendment, the free exercise clause of the first amendment, and the right to associate in marriage protected by the first, fourth, fifth, ninth, and tenth amendments).

State Regulation of Advertising by Investor-Owned Electric Utilities: The Development of Current Standards and Their Constitutional Limits

I. INTRODUCTION

Since 1970 many states have revised their regulatory policies toward electric utility advertising. The general approach of the revisions has been to categorize advertising expenses by ad content and to allow only certain categories of expenses to be passed on to consumers through electricity rates.[1] Typically, state regulatory agencies adopting this approach will no longer allow any expenses for promotional or institutional advertising to be charged to ratepayers.[2] Only advertising which gives consumers information on utility services or on methods of energy conservation can now be included in the rates as an operating expense.[3] This relatively new regulatory attitude is a significant departure from the traditional policy that promotional and institutional advertising are legitimate operating expenses, consistent with the discharge of a public utility's duty to the public.[4]

The new, tougher state regulations are products of the radically changed economic and political climate after the late 1960's. State-of-the-art limitations on affordable improvements in generating technology, heavy inflation, environmental legislation, the energy crisis, and a general acceptance of ecological and consumer protection ethics all combined to put electric utilities and the regulatory agencies under great pressure.[5] Congress responded by enacting Title I of the Public Utility Regulatory Policies Act of 1978 (PURPA).[6]

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[1]See note 64 and accompanying text *infra* for rate cases using this approach.

[2]The categories of utility advertising expenditures in general use by state regulatory agencies are defined at 91 PUB. UTIL. FORT. 47 (Mar. 1, 1973):

> Utility advertising expenditures fall, generally, into four different categories. First, there is institutional advertising which is designed to enhance the corporate image of the utility. Second, there is promotional advertising which is designed to obtain new customers, increase usage by present customers, or to encourage [customers] to select and install appliances using one form of energy in preference to another. Third, there is consumer advertising which is designed to inform the customer of rates, changes in service, benefits available, emergency procedures, and safety precautions. Fourth, there is conservation advertising which is designed to inform the consumer of the means whereby he could conserve energy and reduce his usage.

See note 129 *infra* for the FTC's definition of corporate "image" advertising.

[3]See note 30 *infra* for a brief discussion of the components of operating expense and its use in rate-making.

[4]*See* notes 44-55 *infra* and accompanying text.

[5]*See* notes 55-63 *infra* and accompanying text.

[6]Pub. L. No. 95-617, §§ 101-43, 92 Stat. 3117 (1978) (to be codified in 16 U.S.C. §§ 2611-44 and 42 U.S.C. §§ 6801-08) [hereinafter cited as PURPA]. Title I is headed

One of PURPA's provisions requires state regulatory agencies to exclude the costs of political and promotional advertising from electric utility rates unless the agencies find that such exclusion would not tend to further the purpose of the Act or would not be consistent with applicable state law.[7] PURPA will probably result in judicial review of the traditional standard for electric utility advertising regulation in states which have not already substantially adopted PURPA's approach. The federal due process issue in *West Ohio Gas Co. v. Public Utilities Commission*[8] upon which the traditional standard of advertising regulation was largely based, may be an essential element in a state's decision regarding whether to adopt PURPA's advertising terms.

Neither PURPA nor most of the state policies taking the new, strict approach to advertising regulation prevent electric utilities from using institutional, promotional, or "controversial subject" advertising if utility stockholders bear the costs.[9] The strong public concern about energy policy and the serious problems of the electric power industry indicates, however, that the prohibition of all advertising in some categories may be adopted in states which now have more lenient policies.[10] Because the Supreme Court has ruled that corporate political and commercial speech has some degree of first amendment protection,[11] the constitutional validity of a prohibitory mode of utility advertising control may become a prominent issue if the trend for stricter regulation does not abate.

This Note will assess the constitutional foundation of electric utility advertising regulation, the extent to which the traditional *West Ohio Gas* standard remains valid constitutional law, and the decision's consequent significance for state implementation of

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"Retail Regulatory Policies for Electric Utilities." The Act's other titles are: Title II—"Certain Federal Energy Regulatory Commission and Department of Energy Authorities," Title III—"Retail Policies for Natural Gas Utilities," Title IV—"Small Hydroelectric Power Projects," Title V—"Crude Oil Transportation Systems," and Title VI—"Miscellaneous Provisions."

[7]See notes 70-78 *infra* and accompanying text for the PURPA sections pertinent to this provision.

[8]294 U.S. 63 (1935).

[9]There is evidence that electric utilities will continue promotional, institutional, or political advertising even if stockholders must pay for it. *E.g.*, *Ad Campaigns by State Power Producers Little Hard to Swallow for Citizens Groups*, Indianapolis Star, Jan. 7, 1979, § 3, at 8, col. 3 [hereinafter cited as *Ad Campaigns*] (regarding controversy about major, stockholder-financed advertising campaigns by Indiana utilities).

[10]New York, for example, has recently upheld a prohibition of all electric utility promotional advertising. Consolidated Edison Co. v. Public Serv. Comm'n, 63 A.D.2d 364, 407 N.Y.S.2d 735 (1978).

[11]Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748 (1976) (commercial speech); First Nat'l Bank v. Bellotti, 435 U.S. 765 (1978) (political speech).

PURPA's advertising provision. This Note will also probe the limits to which electric utility advertising may be constitutionally controlled.[12]

II. Traditional Basis for Regulation of Electric Utility Advertising

A. *Legal Foundations and Scope of Regulatory Power*

In *Munn v. Illinois*,[13] the Supreme Court held that the Constitution's fourteenth amendment due process clause[14] permits state regulation of private property which is profit-oriented and "affected with a public interest."[15] The Court in *Munn* ruled that a state law setting the prices that grain elevator operators could charge did not constitute a taking of private property without due process of law, unless the prices allowed were not reasonable compensation to the owners.[16] The Court noted that the fourteenth amendment was based on the common law conception of sovereign police power which permitted government control over the prices charged by ferrymen, common carriers, and others who offered their services to the

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[12]This Note will consider only regulations pertaining to investor-owned public electric utilities. Publicly owned electric utility advertising regulation does not raise constitutional issues under the first and fourteenth amendments. The bulk of the nation's electricity is produced and distributed by the investor-owned firms; according to the FPC, in 1970 the 200 largest investor-owned firms owned and operated more than 75% of the national generating capacity and served about 80% of the nation's electric customers. FPC, The 1970 National Power Survey, pt. 1, ch. 2, at 4 (1971). This Note, therefore, concerns the advertising regulation of the states as it affects the greater part of the nation's consumers.

The direct regulatory authority of the federal government over power supply is beyond the scope of the Note, although it does discuss the implications of PURPA, *supra* note 6, as applied to state regulation. The primary regulatory responsibility under PURPA is assigned to the states. *See* notes 70-77 *infra*. The constitutional issues which are discussed, however, are equally applicable to any federal regulation of privately owned electric company advertising.

This Note does not discuss natural gas utility advertising due to the different nature of the problems besetting the gas industry. Gas is a primary energy form in limited supply, while electricity is a secondary energy form which can be generated from several primary energy sources. Operating efficiencies of the gas and electric industries are also different. However, the state laws governing gas and electricity advertising are similar, so, apart from the policy issues arising from the differences between the two industries, much of the analysis in this Note is applicable to natural gas advertising.

[13]94 U.S. 113 (1876).

[14]"[N]or shall any State deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1, cl. 3.

[15]94 U.S. at 126 (quoting Lord Chief Justice Hale, *De Portibus Maris*, 1 Harg. Law Tracts 78).

[16]*Id.* at 134.

general public.[17] Chief Justice Waite explained the common law rationale by stating:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has created.[18]

Whether a business is "affected with a public interest" was subsequently held to be a matter for legislative determination, subject to judicial review.[19] The impossibility of an exact definition of the phrase resulted in much litigation and varying judicial formulations.[20] Ultimately, the state legislatures uniformly regarded electric power producers as "affected with a public interest" and created commissions to exercise the legislative police power by regulating electric utilities in a manner consistent with the public's interest.[21]

The process of regulation and its review by judicial authority have elaborated upon the scope of a utility's duty to the public, a duty implicit in *Munn's* formulation of the common law basis of private property control by government.[22] The formulations of the duty vary,[23] but the basic standard of the formulations may be stated as follows:

> The distinguishing characteristic of a public utility is the devotion of private property by the owner to such a use that the public generally, or at least that part of the public which has been served and has accepted the service, has the right to demand that such service, so long as it is continued, shall be conducted with reasonable efficiency and under proper charges.[24]

The "reasonable efficiency" element of utility duty allows regulatory

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[17]*Id.* at 123-25.

[18]*Id.* at 126.

[19]Tyson & Brother-United Theatre Ticket Offices, Inc. v. Banton, 273 U.S. 418, 431 (1927).

[20]16 AM. JUR. 2d *Constitutional Law* §§ 315-17 (1964).

[21]A thorough appraisal of the growth and structure of state regulatory agencies is beyond the scope of this Note. For a brief history of the creation of the state public service commissions and an overview of their modern structure and function, see A. FINDER, THE STATES AND ELECTRIC UTILITY REGULATION 16-23 (1977).

[22]94 U.S. 113 (1876).

[23]*See* 64 AM. JUR. 2d *Public Utilities* § 1 (1972).

[24]City of Phoenix v. Kasun, 54 Ariz. 470, 475, 97 P.2d 210, 212 (1939).

authority to reach beyond the control of price to the utility's methods of providing adequate service.[25]

To avoid unconstitutional confiscation, the rates set by government regulation must provide "a fair return upon the value" of the property used by a utility to provide its service. Such rates must not require the public to pay more for the services than they are "reasonably worth."[26] The fair return concept was explained by the Supreme Court as a matter "depend[ing] greatly upon circumstances and locality . . . the amount of risk . . . and the rate expected and usually realized there upon investments of a somewhat similar nature . . . ."[27] A later formula for proper rate-setting included a concern for the utility's fiscal health and its ability to attract capital: "The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."[28]

This concern was given pragmatic effect in the Court's definition of a proper rate calculation by the Federal Power Commission in *FPC v. Hope Nautral Gas Co.*[29] In that case, the Court held that a proper rate must balance the interests of ratepayers and investors, a balance obtained by allowing rates sufficient to cover operating costs, interest on debt, preferred stock dividends, and dividends on common equity equal to those paid by enterprises having similar risks.[30]

B. The Economies of Expansion: Electric Utility Operations Until the Late 1960's

From 1935 to 1967, the cost to produce a kilowatt-hour of electricity declined in the United States.[31] Several factors caused this sustained reduction in cost.

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[25]*See* Louisville & N. R.R. v. Kentucky, 161 U.S. 677, 696 (1896).

[26]Smyth v. Ames, 169 U.S. 466, 547 (1897).

[27]Willcox v. Consolidated Gas Co., 212 U.S. 19, 48 (1909).

[28]Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 693 (1923).

[29]320 U.S. 591 (1944).

[30]*Id.* at 603. State regulatory commissions today generally adhere to this formula. *See* A. FINDER, *supra* note 21, at 25. The revenues required to be generated through a utility's rate structure are equal to the utility's operating expenses (plant, fuel, labor, and management costs, plus taxes) plus its capital costs (interest on debt, retained earnings, dividends on preferred stock, and fair return on common equity). *Id.*

[31]FEDERAL POWER COMMISSION, THE 1970 NATIONAL POWER SURVEY, pt. 1, ch. 1, at 33-34 (1971):

> This long-term trend was in sharp contrast with almost every other price pattern in the American economy. For example, over the period 1940 to 1962,

Electric generating technology was improved by the successful use of ever-larger power plants, which burned fuel at increasingly higher temperatures with consequently greater efficiency.[32] Accordingly, the amount of fuel required to generate a kilowatt-hour was reduced. Improvements in transmission and distribution technology were also made, enabling utilities to deliver power at a lower cost.[33]

The demand for and consumption of electric power greatly increased[34] because of population growth, economic expansion, higher standards of living, and a great proliferation of the varieties of electrically powered devices.[35] The burgeoning demand and consumption enabled the utilities to build technological improvements in power generation into new facilities. Capital to finance the additions was generally available at reasonable cost.[36] As a result, the increases in revenue, required for "reasonable return,"[37] were offset by the lower operating cost per kilowatt-hour resulting from production improvements and by increased revenues from greater sales. This situation possessed all the elements of classic economy of scale.[38]

The utilities were also able to improve their load factor, the ratio of average power demand to peak demand.[39] Because electric power cannot economically be stored for later use, the generating capacity of an electric utility system must be sized to meet the power demand as it occurs. The daily demand on generating capacity will vary with the activities of the region it serves, but the general pattern of electric load will peak during daylight hours, when industrial, commercial, and residential use of electrical equipment is

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during which the average price of electricity—again on a current dollar basis—was reduced by nearly 25%, the average price of consumer goods (consumer price index) rose more than 200%.

[32]*Id.* at 34.

[33]*Id.*

[34]The load doubled approximately every 10 years from the 1880's to 1970. *Id.* ch. 3, at 3. Demand or load is the rate, at any moment, at which power is required. Consumption is the quantity of energy used over time.

[35]*Id.*

[36]*Financial Problems of the Electric Utilities: Hearings Pursuant to S. Res. 45 Before the Sen. Comm. on Interior and Insular Affairs*, 93d Cong., 2d Sess. 429 (1974) [hereinafter cited as *Financial Problems*].

[37]*See* note 30 *supra* and accompanying text.

[38]FEDERAL POWER COMMISSION, THE 1970 NATIONAL POWER SURVEY, pt. 1, ch. 1, at 34 (1971).

[39]*National Energy Act: Hearings on H.R. 6831, H.R. 687, H.R. 1562, H.R. 2088, H.R. 2818, H.R. 3317, H.R. 3664, H.R. 6660 Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce*, 95th Cong., 1st Sess., pt. 3, vol. 1, at 143 (1977) [hereinafter cited as *Energy Act Hearings*]. (These bills were later substantially incorporated into PURPA, *supra* note 6. *Compare* PURPA § 113(b)(5) *with* H.R. 6660 § 312(a)) 95th Cong., 1st Sess. (1977).

greatest, and will be lowest in the early morning.[40] Increases in the use of equipment during the periods of lower demand provided the utilities with better utilization of their power plants, so that the ratio of kilowatt-hours sold to total kilowatts of generating capacity increased and more revenue was available to pay the "fair return" on the debt and equity represented by the utility plants.[41] Demand levels historically varied with seasons as well as with the time of day.[42] Until the early 1950's, the highest demand on utility systems occurred during the winter. With the advent of commercial and residential air-conditioning equipment, however, the disparity between winter and summer demands began to diminish, so that by the early 1960's the composite national load factor was at its highest.[43]

C. The Regulatory Response to the Economies of Expansion: Advertising and the West Ohio Gas Standard

The favorable conditions for the growth of the electric power industry were inextricably bound to the expansion of the national economy. During this period the regulatory commissions adopted the policy that demand for power should be met in order to encourage economic growth. Accordingly, they approved rate designs which favored greater electric consumption. These rate designs, submitted by the utilities, took the form of "declining blocks" rewarding higher levels of consumption with a lower unit cost.[44]

Because the expansion of demand led to the reduction of energy costs by providing a market for new, technologically superior utility plants and because the demand growth itself was seen as an integral aspect of economic progress, the regulatory commissions accepted active promotion of increased consumption as a proper operating expense of an electric utility.[45] Promotional advertising was integral to the utility load growth effort.[46] While advertising's effect upon actual growth was not generally capable of factual demonstration before a commission, the benefits of promotional advertising were,

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[40]FEDERAL POWER COMMISSION, THE 1970 NATIONAL POWER SURVEY, pt. 1, ch. 3, at 1-2 (1971).

[41]An example of the type of equipment-improving load factor is street lighting.

[42]*Energy Act Hearings, supra* note 39, pt. 3, vol. 1, at 143.

[43]*Id.*

[44]A. FINDER, *supra* note 21, at 47.

[45]*See Promotional Practices By Public Utilities and Their Impact Upon Small Business: Hearings Pursuant to H. Res. 53 Before the Subcomm. on Activities of Regulatory Agencies of the House Select Comm. on Small Business*, 90th Cong., 2d Sess. A195-217 (1968) [hereinafter cited as *Promotional Practices*].

[46]*Id.* at 710-25 (exhibits of advertisements for appliances and appliance-related services).

in principle, justifiable as part of the active policy to promote growth of capacity and supply.[47] Institutional advertising was also an acceptable operating expense because it was considered to improve the utility's image as a good investment and, hence, to help provide the capital required to build new facilities.[48]

The regulatory attitude toward electric utility advertising during the expansion-oriented era was heavily reliant upon Justice Cardozo's majority opinion in *West Ohio Gas*.[49] The portion of the case concerning advertising involved unconstitutional confiscation by the Ohio Public Utilities Commission in its arbitrary disallowance of promotional expenses submitted by a gas company as an operating expense. Cardozo emphasized that a public utility is a private business venture whose managers must have reasonable flexibility in the discharge of the business' duty to the public:

> Good faith is to be presumed on the part of the managers of a business. In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay. The suggestion is made that there is no evidence of competition. We take judicial notice of the fact that gas is in competition with other forms of fuel, such as oil and electricity. A business never stands still. It either grows or decays.[50]

The presumption that growth is an integral aspect of the health of a business, notwithstanding that it is regulated, makes advertising to promote business expansion in the face of competition a legitimate operating expense: "Within the limits of reason, advertising or development expenses to foster normal growth are legitimate charges upon income for rate purposes as for others."[51]

The competitive aspects of an energy business and advertising's effectiveness in maintaining the fiscal health of a public utility were key principles to the holding that promotional expense was

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[47]*See, e.g.*, Letter from Lee C. White, Chairman of FPC, to Rep. John D. Dingell (Oct. 18, 1968), *reprinted in Promotional Practices, supra* note 45, at 743-44 (discussing acceptability of promotional rates to encourage off-peak load growth).

[48]*E.g.*, Consolidated Edison, 41 PUB. U. REP. 3d (PUR) 305, 364 (1961):

> What is of concern here are advertisements which are obviously designed to project a favorable image of the company to its customers, its existing stockholders or potential investors. To the extent that such advertising fosters sound consumer relations or encourages people to invest in the company, it seems clear that the consumers, as well as the stockholders, are ultimately benefited through the lessening of the expense of doing business.

[49]294 U.S. at 72.

[50]*Id.* (citations omitted).

[51]*Id.*

legitimately chargeable to the ratepayers.[52] To disallow advertising expenses without evidence that the advertising was unnecessary for the utility to provide its service would be to pass beyond regulation to usurpation of business management and to confiscation of private property without due process. Regulatory commissions had the duty to oversee, not to plan or administer.

As the cost of electricity continued to decrease while demand grew and the economy flourished, promotional and institutional advertising were routinely approved and included in rate structures by regulatory commissions.[53] If the need to pass the cost of such advertising on to consumers was questioned, state judicial review adhered to Cardozo's standard in *West Ohio Gas.*[54]

III. The New Climate and Changing Perceptions of the Role of Regulation: Current Advertising Policies

A. The Rapid Demise of the Expansion Policy

Since the late 1960's, the economies to be obtained from the expansion of electric demand have largely vanished. Growth has become a dilemma rather than a desirable goal. The reasons for this

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[52]*Id.* In his remarks on the legitimacy of advertising as operating expense, note 51 *supra* and accompanying text, Cardozo cited Consolidated Gas Co. v. Newton, 267 F. 231 (S.D.N.Y. 1920), which concerned in part the propriety of advertising undertaken in response to the plaintiff gas company's market share:

> The truth appears to be that the constantly increasing use of electricity for illumination has driven out gas more and more, until to hold its sales the plaintiff must promote the use of gas for heating and cooking. It has succeeded in a slight increase of sales, and its officers attribute their ability to do even so well to these departments. I have no doubt that they are right; but, whether right or wrong, their decision is not now open to question. They were under a duty to keep up their sales so far as they could, and to push the use of gas in any new ways which the public would use it. Even under municipal management, advertisement, when not pushed to the useless extreme which competition too often engenders, is a necessary function. In its proper sense it means, not the creation of a factitious demand by the familiar processes of repeated suggestion, but genuine information in such form as to reach the public.

Id. at 253.

[53]*E.g.*, Arkansas La. Gas Co., 40 Pub. U. Rep. 3d (PUR) 209 (Ark. Pub. Serv. Comm'n 1961); Southern Cal. Gas Co., 35 Pub. U. Rep. 3d (PUR) 300 (Cal. Pub. Util. Comm'n 1960); Promotional Activities by Gas & Elec. Corps., 68 Pub. U. Rep. 3d (PUR) 162 (N.Y. Pub. Serv. Comm'n 1967).

[54]City of El Dorado v. Public Serv. Comm'n, 235 Ark. 812, 362 S.W.2d 680 (1962); Gifford v. Central Me. Power Co., 160 Me. 136, 217 A.2d 200 (1966); Public Serv. Co. v. State, 102 N.H. 150, 153 A.2d 801 (1959). *But see* Southwestern Elec. Power Co. v. FPC, 304 F.2d 29 (5th Cir.), *cert. denied*, 371 U.S. 924 (1962) (holding FPC had power to transfer advertising expenses on benefits of private versus public power from expense accounts charged to ratepayers to accounts charged to stockholders).

change are beyond the scope of this Note, but a brief assessment is essential to an understanding of the current regulation of electric utility advertising and of the pressures for its strict control.

It is no longer true that expanded generating and transmission capacity reduce the cost to produce electricity. The efficiencies to be gained from economies of scale in generating capacity are not sufficient[55] to offset the increased costs of both the construction of new power plants and the fuel they use.[56]

Demand for power continues to increase rapidly, though estimates of future growth indicate it will no longer double every ten years.[57] The summer peak demand has outstripped the winter peak nationally, due to air-conditioning load growth, so that the national load factor is declining.[58] This problem is exacerbated by the failure of the declining block rate design to relate the actual cost of higher levels of power consumption during peak demand to the price charged. The social and the environmental costs of additional power plants, needed to meet increased demand, are too high.[59]

These changes have caused declining stock prices[60] and have forced the utilities to obtain new construction financing at inflated interest rates.[61] To offset these problems, the utilities have had to increase their rates rapidly,[62] despite intense opposition from outraged consumer groups.[63]

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[55]A. FINDER, *supra* note 21, at 1. One writer suggested that some efficiencies are still to be obtained from larger plants but that the size of the utility's operating territory itself functions as a limit upon the size of the generating unit which can be built, so that mergers among existing utilities or joint construction of super plants by consortiums of utilities are necessary to obtain the cost benefits of bigger plants. Hughes, *Scale Frontiers in Electric Power*, in TECHNOLOGICAL CHANGE IN REGULATED INDUSTRIES (W. Capron ed. 1971).

[56]*Energy Act Hearings*, *supra* note 39, pt. 3, vol. 1, at 78-79 (written testimony of D. Bardin, Deputy Adminstrator of the Federal Energy Agency).

[57]*Id.* at 79.

[58]*Id.* at 143.

[59]The undesirability of unrestrained increases in environmental pollution has been recognized and addressed in much legislation at both state and federal levels. *See, e.g.*, National Environmental Policy Act of 1969, 42 U.S.C. § 4321 (1976).

[60]*Electric Utility Rate Reform and Regulatory Improvement, Hearings on H.R. 12461, H.R. 2633 and H.R. 2650 (Titles VII and VIII), H.R. 6696, H.R. 10869, H.R. 11449, H.R. 11475, H.R. 12848, H.R. 12872 (and all identical, similar, and related bills) Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess., pt. 1, 227 (1976) (statement of W.D. Crawford).

[61]A. FINDER, *supra* note 21, at 8.

[62]*Energy Act Hearings*, *supra* note 39, pt. 3, vol. 1, at 68-75 (statement of D. Bardin).

[63]For an example of the increasing sophistication of consumer groups hostile to electric utilities and of the breadth of their opposition to utility practices, see R. MORGAN & S. JERABEK, HOW TO CHALLENGE YOUR LOCAL ELECTRIC UTILITY (1974) (publication of the Environmental Action Foundation).

B. A Reassessment of the Proper Scope of Advertising Regulation

In response to the exigencies of the power situation and to public criticism, the regulatory agencies in many states have reacted by categorizing utility advertising content and by refusing to allow the costs of promotional and institutional advertising as operating expenses.[64] This policy has been adopted to remove incentives for increased consumption and to remove an unpopular cost from the rates. A few state agencies have adopted a prohibitory mode of regulation. New York has banned promotional advertising.[65] The Oklahoma Corporation Commission announced in 1975 that it would prohibit promotional and institutional ads, but subsequent state judicial review overruled the Commission order.[66] As yet no states have prohibited any controversial subject, conservation, or consumer information advertising.

One state has refused to adopt the categorical classification system because the definitional categories are viewed as obscuring the actual content of the advertising concerned. Advertising expenses under this non-categorical approach, however, are allowed as operating expenses only if they provide consumer service or conservation information.[67]

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[64]Arkansas Power & Light Co., 15 PUB. U. REP. 4th (PUR) 153, 176-77 (Ark. Pub. Serv. Comm'n 1976); Southern Cal. Edison Co., 100 PUB. U. REP. 3d (PUR) 257, 278-81 (Cal. Pub. Util. Comm'n 1973); Public Serv. Co., 13 PUB. U. REP. 4th (PUR) 40, 58 (Colo. Pub. Util. Comm'n 1975) (but promotional ads increasing off-peak use allowed); Promotional Practices of Elec. Utils., 8 PUB. U. REP. 4th (PUR) 268, 275-76 (Fla. Pub. Serv. Comm'n 1975); Tampa Elec. Co., 9 PUB. U. REP. 4th (PUR) 402, 414 (Fla. Pub. Serv. Comm'n 1975); Kansas Gas & Elec. Co., 11 PUB. U. REP. 4th (PUR) 504 (Kan. Corp. Comm'n 1975) (abstract of order disallowing institutional ads but allowing promotional ads tending to improve load factor); Potomac Elec. Power Co., 10 PUB. U. REP. 4th (PUR) 13, 19-20 (Md. Pub. Serv. Comm'n 1975); Northern States Power Co., 11 PUB. U. REP. 4th (PUR) 385, 402 (Minn. Pub. Serv. Comm'n 1975); Montana Power Co., 96 PUB. U. REP. 3d (PUR) 265, 277 (Mont. Pub. Serv. Comm'n 1972); Duke Power Co., 88 PUB. U. REP. 3d (PUR) 230, 239-40 (N.C. Utils. Comm'n 1971); Northern States Power Co., 10 PUB. U. REP. 4th (PUR) 489 (N.D. Pub. Serv. Comm'n 1975) (abstract of rate case); Northern States Power Co., 6 PUB. U. REP. 4th (PUR) 38, 42 (N.D. Pub. Serv. Comm'n 1974) (institutional ads not allowed, but promotional ads considered proper advertising expense); Utility Advertising Expenditures, 14 PUB. U. REP. 4th (PUR) 578 (Ore. Pub. Util. Comm'n 1976) (abstract of order); Pacific Power & Light Co., 14 PUB. U. REP. 4th (PUR) 578 (Ore. Pub. Util. Comm'n 1976) (abstract of case); Narragansett Elec. Co., 1 PUB. U. REP. 4th (PUR) 60, 67 (R.I. Pub. Utils. Comm'n 1973); Northwestern Pub. Serv. Co., 22 PUB. U. REP. 4th (PUR) 60, 83-84 (S.D. Pub. Util. Comm'n 1977); Wisconsin Power & Light Co., 4 PUB. U. REP. 4th (PUR) 305, 308-09 (Wis. Pub. Serv. Comm'n 1974).

[65]Consolidated Edison Co. v. Public Serv. Comm'n, 63 A.D.2d 364, 407 N.Y.S.2d 735 (1978).

[66]State v. Oklahoma Gas & Elec. Co., 536 P.2d 887, 897 (Okla. 1975).

[67]Consumers Power Co., 3 PUB. U. REP. 4th (PUR) 321, 332-34 (Mich. Pub. Serv. Comm'n 1974).

Advertising regarding the benefits of nuclear power has received varying regulatory treatment. Maine and Wisconsin have concluded that such advertising conveys valuable information to both consumers and investors on the superior reliability and economy of nuclear power to both consumers and investors and that this advertising, therefore, is properly included in electric rates, even though nuclear generation is a controversial subject and opposed by significant segments of the public.[68] New York has ruled that advertising costs promoting nuclear power should not be passed on to consumers because nuclear generation is a controversial public policy matter upon which a utility should not be allowed to take a position at consumer expense.[69]

The impact of PURPA upon these state policies is difficult to predict. Title I of the Act[70] is intended to cause the states to reassess and strengthen their regulation of electric utility rates. The title's stated purpose is to encourage conservation of electricity, efficient use of utility facilities, and equitable consumer rates.[71] State regulatory agencies are required to consider whether Title I's purpose would be furthered by state implementation of specified federal standards,[72] one of which is the exclusion of promotional and

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[68]Central Me. Power Co., 15 PUB. U. REP. 4th (PUR) 455, 475 (Me. Pub. Util. Comm'n 1976) (nuclear power a subject upon which management may take and advertise a public position); Wisconsin Elec. Power Co., 9 PUB. U. REP. 4th (PUR) 204, 219 (Wis. Pub. Serv. Comm'n 1975) (substantial benefits of on-line nuclear plant a proper institutional ad operating expense to attract investors).

[69]Consolidated Edison Co. v. Public Serv. Comm'n, 63 A.D.2d 364, 407 N.Y.S.2d 735 (1978).

[70]Note 6 *supra*.

[71]PURPA, *supra* note 6, § 101 (to be codified at 16 U.S.C. § 2611) provides: "The purposes of this title are to encourage—(1) conservation of energy supplied by electric utilities; (2) the optimization of the efficiency of use of facilities and resources by electric utilities; and (3) equitable rates to electric consumers." The Act, however, applies only to larger utilities. Section 102(a) (to be codified at 16 U.S.C. § 2612) provides:

> This Title applies to each electric utility in any calendar year, and to each proceeding relating to each electric utility in such year, if the total sales of electric energy by such utility for purposes other than resale exceeded 500 million kilowatt-hours during any calendar year beginning after December 31, 1975, and before the immediately preceding calendar year.

[72]*Id.* Section 111 (to be codified at 16 U.S.C. § 2621) requires state regulatory agencies to consider whether the Act's purposes would be furthered by implementing federal standards for rate reform, including time-of-day rates relating price to time of daily use, seasonal rates providing for seasonal price differentials related to seasonal generation cost variations, and other rate changes. Section 112 (to be codified at 16 U.S.C. § 2622) requires the state agencies to make their considerations of the § 111 standards in formal hearings held no later than two years after the Act's passage. Section 113 (to be codified at 16 U.S.C. § 2623), aside from the advertising standard, note 73 *infra*, provides for state regulatory consideration of federal standards for "automatic adjustment clauses" (commonly known as fuel adjustment clauses), con-

"political" advertising[73] costs from consumer rates.[74] The states are not required to adopt the federal advertising standard if the state

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sumer information, procedures for disconnecting electric service for nonpayment of bills, and metering for multiple-occupancy buildings. Section 114 (to be codified at 16 U.S.C. § 2624) allows exceptions for "lifeline rates" which give subsistence levels of electricity to low-income consumers at prices lower than cost and which hence do not conform with the rate reform provisions of § 111. For a brief survey of PURPA's Title I, see Partridge, *A Road Map to Title I of the Public Utility Regulatory Policies Act of 1978*, 101 PUB. UTIL. FORT. 16 (Jan. 18, 1979).

[73]PURPA, *supra* note 6, § 115(h) (to be codified at 16 U.S.C. § 2625) defines promotional and "political" advertising and distinguishes them from other types of advertising:

> (1) For purposes of this section and section 113(b)(5)—
>
> (A) The term "advertising" means the commercial use, by an electric utility, of any media, including newspaper, printed matter, radio, and television, in order to transmit a message to a substantial number of members of the public or to such utility's electric consumers.
>
> (B) The term "political advertising" means any advertising for the purpose of influencing public opinion with respect to legislative, administrative, or electoral matters, or with respect to any controversial issue of public importance.
>
> (C) The term "promotional advertising" means any advertising for the purpose of encouraging any person to select or use the service or additional service of an electric utility or or the selection or installation of any appliance or equipment designed to use such utility's service.
>
> (2) For purposes of this subsection and section 113(b)(5), the terms "political advertising" and "promotional advertising" do not include—
>
> (A) advertising which informs electric consumers how they can conserve energy or can reduce peak demand for electric energy,
>
> (B) advertising required by law or regulation, including advertising required under part 1 of title II of the National Energy Conservation Policy Act,
>
> (C) advertising regarding service interruptions, safety measures, or emergency conditions,
>
> (D) advertising concerning employment opportunities with such utility,
>
> (E) advertising which promotes the use of energy efficient appliances, equipment or services, or
>
> (F) any explanation or justification of existing or proposed rate schedules, or notifications of hearings thereon.

Note that § 115(h) does not refer to institutional advertising as defined in note 2 *supra*. This suggests that the courts may be faced with the question whether institutional advertising falls into either the "promotional" definition of § 115(h)(B) or the "political" definition of § 115(h)(C). Nuclear power advertising has been held to be institutional in nature by some regulatory commissions which have also recognized that the nuclear power issue is controversial. *See* note 68 *supra* and accompanying text. New York has ruled that nuclear power ads concern a controversial public policy issue. *See* note 69 *supra* and accompanying text.

[74]*Id.* Section 113(b)(5) (to be codified at 16 U.S.C. § 2623) provides: "No electric utility may recover from any person other than the shareholders (or other owners) of

regulators find that the Act's purpose would not be served thereby or if the standard is not consistent with applicable state law.[75]

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such utility any direct or indirect expenditure by such utility for promotional or political advertising as defined in section 115(h)."

[75]*Id.* Sections 113(a) and (c) (to be codified at 16 U.S.C. § 2623) provide:

> (a) . . . Not later than two years after the date of the enactment of this Act, each State regulatory authority (with respect to each electric utility for which it has ratemaking authority), and each nonregulated electric utility, shall provide public notice and conduct a hearing respecting the standards estabished by subsection (b) and, on the basis of such hearing, shall—
>
> (1) adopt the standards established by subsection (b) (other than paragraph (4) thereof) if, and to the extent, such authority or nonregulated electric utility determines that such adoption is appropriate to carry out the purposes of this title, is otherwise appropriate, and is consistent with otherwise applicable State law . . . .
>
> . . . .
>
> For purposes of any determination under paragraphs (1) . . . any review of such determination in any court in accordance with section 123, the purposes of this title supplement otherwise applicable State law. Nothing in this subsection prohibits any State regulatory authority or nonregulated electric utility from making any determination that it is not appropriate to adopt such standard, pursuant to its authority under otherwise applicable State law.
>
> . . . .
>
> (c) . . . Each State regulatory authority (with respect to each electric utility for which it has ratemaking authority) and each nonregulated electric utility, within the two-year period specified in subsection (a), shall (1) adopt, pursuant to subsection (a), each of the standards established by subsection (b) or, (2) with respect to any such standard which is not adopted, such authority or nonregulated electric utility shall state in writing that it has determined not to adopt such standard, together with the reasons for such determination. Such statement of reasons shall be available to the public.

Id. Sections 117(a) and (b) (to be codified at 16 U.S.C. § 2627) clearly indicate that state regulatory agencies are not constrained by PURPA to adopt any advertising standard inconsistent with state law:

> (a) . . . Nothing in this title shall authorize or require the recovery by an electric utility of revenues, or of a rate of return, in excess of, or less than, the amount of revenues or the rate of return determined to be lawful under any other provision of law.
>
> (b). . . Nothing in this title prohibits any State regulatory authority or nonregulated electric utility from adopting, pursuant to State law, any standard or rule affecting electric utilities which is different from any standard established by this subtitle.

The provision in § 113(a) for PURPA to supplement state regulatory authority is apparently not intended to give state regulators authority to adopt any policy which it is clear they are prohibited from adopting under state law, but if their authority is unclear the federal law is meant to enable them to act:

> The conferees intend that the discretion under this title of a State regulatory authority or nonregulated electric utility to adopt the standards established by section 113 or not to adopt them . . . is very broad, so long as the requirements of this title are met. Such authority and utility are not required by these sections to adopt or implement such standards. However,

Under this provision the state policies which are not consistent with PURPA would not have to be revised to conform with the federal law if the state regulators determined that their present policies are more likely to achieve Title I's purpose.

PURPA's terms require only a regulatory finding that the federal standard is inappropriate.[76] Another PURPA provision, however, allows any party who participates in the state regulatory proceeding to recover his litigation costs, including attorney fees, from the affected utility if he successfully appeals the regulatory decision in state court and, by doing so, substantially contributes to the ultimate approval of a position he espoused before the regulatory agency.[77] This provision substantially increases the

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any provisions of State law or regulations that may require such adoption or implementation are not affected by this title.

The conferees wish to emphasize that for purposes of the determination in accordance with paragraph (1) or (2) of section 113 and for the purposes of any review of the consideration and determination in any court, the purposes of this title shall supplement State law.

It should be noted that the test of consistency with State law, as described in section 113(a)(1) and (2) is with respect to State law alone and not with respect to State law as supplemented by the three purposes of the title. The intent here is that where a State regulatory commission or nonregulated utility finds insufficient authority pursuant to otherwise applicable State law, under which it may adopt a standard established in section 113, then these three purposes of the title provide such authority. In effect the three purposes expand the discretion of the State regulatory commission or nonregulated utility to adopt the standards of section 113. However, the conferees also intend that three [*sic*] purposes do not override State law.

JOINT COMM. OF CONFERENCE ON H.R. 4018, JOINT EXPLANATORY STATEMENT OF THE COMM. OF CONFERENCE, H. CONF. REP. NO. 95-1750, 95th Cong., 2d Sess. 75 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 7975, 7987. The distinction between "insufficient authority" and authority assumed in violation of state law by a regulatory commission unsure of the extent of its power under state law to adopt PURPA's standard is a fine one which may generate state review of the regulatory authority to make the findings encouraged by PURPA. See notes 82, 88, 90, 91 *infra* and accompanying text for three similar regulatory enabling statutes and the differing judicial constructions of the authority they confer to regulate electric utility advertising.

[76]Note 75 *supra*.

[77]PURPA, *supra* note 6. Sections 122(a) and (b) (to be codified at 16 U.S.C. § 2632) provide:

Consumer representation:

(a) . . . (1) If no alternative means for assuring representation of electric consumers is adopted in accordance with subsection (b) and if an electric consumer of an electric utility substantially contributed to the approval, in whole or in part, of a position advocated by such consumer in a proceeding concerning such utility, and relating to any standard set forth in subtitle B [including § 113(b)(5) on advertising], such utility shall be liable to compensate such consumer . . . for reasonable attorneys' fees, expert witness fees, and other reasonable costs incurred in preparation and advocacy of such position

likelihood that a regulatory determination against PURPA's advertising terms will be subjected to state judicial review. In particular, regulatory determinations that applicable state law precludes adoption of PURPA are apt to be appealed and, in states which have adhered to the traditional, *West Ohio Gas*[78] position that electric utility advertising costs are properly absorbed by consumers, *West Ohio Gas* will probably receive attention in any such litigation.

IV. Constitutional Limitations Upon State Regulation of Electric Utility Advertising

A. Recent State Judicial Review, West Ohio Gas, and the Due Process Clause

Few state courts have considered the propriety of the tougher regulatory policies toward electric utility advertising. Those decisions have interpreted *West Ohio Gas* in conflicting ways and frame an issue which is likely to be brought before other state courts as a result of PURPA.

As discussed above, the common state regulatory approach to electric utility advertising in recent years has been to categorize advertisements in terms of content and to either exclude certain categories from operating expense or to ban all advertising of certain types. The use of content categories itself was held to be an unreasonable and confiscatory mode of regulation in *Alabama Power Co. v. Alabama Public Service Commission.*[79] The issue in that case was the propriety of the Commission's exclusion of advertising costs from operating expense on the grounds that the advertising content was within an institutional category. The Alabama Supreme Court held that the use of content categories to determine whether advertising costs would be included in rate calculations was beyond the Commission's authority under the Alabama Code[80] which was inter-

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in such proceeding (including fees and costs of obtaining judicial review of any determination made in such proceeding with respect to such position).

. . . .

(b) . . . Compensation shall not be required under subsection (a) if the State . . . has provided an alternative means for providing adequate compensation

. . . .

[78]294 U.S. 63 (1935).

[79]359 So. 2d 776 (Ala. 1978).

[80]Ala. Code § 37-1-80 (Supp. 1978) provides:

The rates and charges for the services rendered and required shall be reasonable and just to both the utility and the public. Every utility shall be entitled to such just and reasonable rates as will enable it at all times to fully perform its duties to the public and will, under honest, efficient and economical management, earn a fair net return on the reasonable value of its property devoted to the public service . . . . In any determination of the commission as to what constitutes such a fair return, the commission shall give

preted to incorporate the *West Ohio Gas* opinion as a bar to usurpation of management functions by state regulation.[81] Under the Alabama view, the use of advertising categories to determine operating expenses improperly presumes what constitutes legitimate public utility management decisions, and is, in that sense, confiscatory. This view assigns the primary responsibility for energy decisions to the utility and is similar to the traditional state regulation applied during the boom periods of electric power industry growth. The Alabama Commission, however, does have the authority under this opinion to hear each rate case on its merits and to determine which advertising expenses are the products of "honest, efficient and economical management"[82] and, thus, are proper to include in rate calculations. The Commission cannot presume that one type of advertising is per se an illegitimate means of providing reliable utility service at reasonable cost.

In *State v. Oklahoma Gas & Electric Co.*,[83] the categorization of advertising content to determine operating expense was considered to be a proper use of regulatory power,[84] but an outright ban on

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due consideration among other things to the requirements of the business with respect to the utility under consideration, and the necessity, under honest, efficient and economical management of such utility, of enlarging plants, facilities and equipment of the utility under consideration, in order to provide that portion of the public served thereby with adequate service.

[81]359 So. 2d at 780. The court stated:

> Advertising is of vital importance to corporations in establishing and maintaining their public image, as well as in educating the consuming public. As such, it is a responsibility of the duly authorized manager of a utility to decide the type, quantity, or form of advertising which would most benefit the corporation in its continued growth. The Utility has the initial right to decide the amount and type of advertisement which comports with good management practices. The function of the Alabama Public Service Commission is that of regulation, and not of management. The Commission should not be allowed to interfere with the proper operation of the utility as a business concern by usurping managerial prerogatives.

Id.

[82]ALA. CODE § 37-1-80 (Supp. 1978).

[83]536 P.2d 887 (Okla. 1975). This case is discussed in depth in Note, *Public Utilities: The Allowance of Advertising Expenditures for Rate-Making Purposes—Is This Trip Really Necessary?*, 29 OKLA. L. REV. 202 (1976). The author argued that promotional and institutional advertising expenses should not be borne by consumers and that prohibition of all promotional energy utility advertising is in the public interest. The Note does not address constitutional issues, except to say that prohibition of promotional advertising may abridge the utility stockholders' rights. The Note was written before Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748 (1976), established first amendment protection for commercial speech.

[84]536 P.2d at 894 (institutional advertising), 896 (promotional advertising). New Hampshire has taken this approach. Public Serv. Co. v. State, 113 N.H. 497, 311 A.2d 513 (1973).

advertising on the basis of categories was held to be unreasonable.[85] The Oklahoma Supreme Court held that a categorical ban of promotional and institutional advertising by state utilities crossed the line between management and regulation and, thus, exceeded the Oklahoma Corporation Commission's statutory authority.[86] The court held that the utility had the burden of proving that the advertising expenses benefited all ratepayers.[87]

In contrast to the Oklahoma and Alabama positions, a prohibition on all promotional advertising was held to be within the power of the New York Public Service Commission in *Consolidated Edison Co. v. Public Service Commission.*[88] The opinion did not mention *West Ohio Gas* and relied heavily on the Commission's finding that promotional advertising was not in the public interest.

In these cases, the state statutes pertaining to regulatory authority were similar in content[89] but were construed to give com-

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[85]536 P.2d at 897.

[86]OKLA. STAT. ANN. tit. 17, § 152 (West 1953) provides:

> The Commission shall have general supervision over all public utilities, with power to fix and establish rates and to prescribe rules, requirements and regulations, affecting their services, operation, and the management and conduct of their business; shall inquire into the management of the business thereof, and the method in which same is conducted. It shall have full visitorial and inquisitorial power to examine such public utilities, and keep informed as to their general conditions, their capitalization, rates, plants, equipments, apparatus, and other property owned, leased, controlled or operated, the value of same, the management, conduct, operation, practices and services; not only with respect to the adequacy, security and accommodation afforded by their service, but also with respect to their compliance with the provisions of this act, and with the Constitution and laws of this state, and with the orders of the Commission.

[87]536 P.2d at 894-96. *Accord, In re* Hawaiian Elec. Co., 56 Haw. 260, 535 P.2d 1102, 1108-09 (1975).

[88]407 N.Y.S.2d 735 (App. Div. 1978). The court held that the Commission had authority to prohibit promotional advertising, citing the following statutory provisions:

> Whenever the commission shall be of opinion, after a hearing had upon its own motion or upon complaint, that the rates, charges or classifications or the acts or regulations of any such person, corporation or municipality are unjust, unreasonable, unjustly discriminatory or unduly preferential or in anywise in violation of any provision of law, the commission shall determine and prescribe in the manner provided by and subject to the provisions of section seventy-two of this chapter the just and reasonable rates, charges and classifications thereafter to be in force for the service to be furnished.

N.Y. PUB. SERV. LAW § 66(5) (McKinney 1955) (in pertinent part).

> The commission shall encourage all persons and corporations subject to its jurisdiction to formulate and carry out long-range programs, individually or cooperatively, for the performance of their public service responsibilities with economy, efficiency, and care for the public safety, the preservation of environmental values and the conservation of natural resources.

Id. § 5(2) (Supp. 1978).

[89]*Compare* the statutes in notes 82, 88, 90 *supra, with* the exception of N.Y. PUB.

missions significantly different power to regulate electric utility advertising. Each decision suggests a different interpretation of the nature of proper regulation and of *West Ohio Gas*. The conflict between the decisions suggests that *West Ohio Gas* should be reexamined, in light of subsequent Supreme Court cases, to determine the limitations of the fourteenth amendment due process clause upon regulation of utility advertising. *West Ohio Gas* can obviously be interpreted in differing ways in determining whether regulatory limits upon advertising are proper under state law, but the case itself was decided on federal constitutional grounds and its authority as constitutional doctrine should be separated from its use to support state law. The current constitutional significance of *West Ohio Gas* may not preclude conflicting state positions, but it should have some import in the re-evaluation of state law on the extent to which regulatory authority controls electric utility advertising.

An initial issue is whether *West Ohio Gas* grants a regulated business an unqualified right to advertise in any manner it chooses at customer expense. For sometime prior to *West Ohio Gas*, the Court interpreted the due process clause to grant such substantive economic rights,[90] but this doctrine was abandoned a year before *West Ohio Gas*, in *Nebbia v. New York*.[91] *West Ohio Gas* may suggest that "normal growth"[92] is an essential aspect of a business venture with which a state cannot constitutionally interfere. However, "normal growth" was perceived in *West Ohio Gas* as a means to a regulatory goal rather than as a due process limitation on regulation. The holding was based on an awareness of the need for a regulated business to have sufficient income to keep it viable, so that it could maintain service to its customers.[93] At the time *West Ohio Gas* was decided, energy utilities were subject to severe competition.[94] In that context, "normal growth" fostered by advertising was a response to a condition threatening a utility's market and its

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SERV. LAW § 5, *supra* note 93. They are all as general as the Supreme Court's standards, notes 26-30 *supra* and accompanying text.

[90]291 U.S. 502 (1934). (State control of milk prices held not to violate due process).

[91]The classic embodiment of this approach is Lochner v. New York, 198 U.S. 45 (1905), in which a New York law regulating bakery work hours was stricken as a denial of the liberty to contract protected by the fourteeneth amendment due process clause. On economic due process and its demise, see G. GUNTHER, CASES AND MATERIALS ON CONSTITUTIONAL LAW 548-96 (9th ed. 1975); Gunther, *Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection*, 86 HARV. L. REV. 1 (1972); McCloskey, *Economic Due Process and the Supreme Court: An Exhumation and Reburial*, 1962 SUP. CT. REV. 34.

[92]294 U.S. at 72.

[93]See note 52 *supra* and accompanying text.

[94]*E.g.*, the quotation from *Consolidated Gas Co.*, note 52 *supra*.

financial health. Under such conditions, exclusion of advertising expenses from retail energy rates, without evidence that the expenses were excessive, would have discouraged utility management from using a business tool indispensible to the continued discharge of the utility's public duty. *West Ohio Gas*'s "normal growth" and advertising are management responses to economic conditions and are not to be unreasonably impaired by regulation unless evidence indicates that the conditions have abated. Recovery of advertising expenses is, hence, dependent on the presence of competition and not an unqualified, substantive due process right.

Read in this light, *West Ohio Gas* is not inconsistent with current Court authority regarding the due process standard of state economic regulation. The standard is essentially that contained in *Nebbia*:

> [The fifth and fourteenth amendments] do not prohibit governmental regulation for the public welfare. They merely condition the exertion of the admitted power, by securing that the end shall be accomplished by methods consistent with due process. And the guaranty of due process, as has often been held, demands only that the law shall not be unreasonable, artibrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained.[95]

The Court stated, in a later case,[96] that evaluation of the end to be attained and the means used requires only a rational relation between the end and the means—a relation which need not be supported by a showing of the facts relied on by the legislative authority in making the regulation:

> [T]he existence of facts supporting the legislative judgment is to be presumed, for regulatory legislation affecting ordinary commercial transactions is not to be pronounced unconstitutional unless in the light of the facts made known or generally assumed it is of such a character as to preclude the assumption that it rests upon some rational basis within the knowledge and experience of the legislators.[97]

Under this standard, the judgment of a regulatory agency exercising the police power of a state legislature is to be presumed to com-

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[95]291 U.S. at 525.

[96]United States v. Carolene Prods. Co., 304 U.S. 144 (1938).

[97]*Id.* at 152. *Accord*, Ferguson v. Skrupa, 372 U.S. 726 (1963); Williamson v. Lee Optical Co., 348 U.S. 483 (1955); Day-Brite Lighting, Inc. v. Missouri, 342 U.S. 421 (1952); Olsen v. Nebraska, 313 U.S 236 (1941).

port with the requirements of due process if it appears to have a proper concern for the public welfare and protects that concern by means which have only a plausible efficacy.[98]

In *West Ohio Gas*, the exclusion of utility advertising expenses from consumer rates did not have this "rational basis." Justice Cardozo took judicial notice of the debilitating effect which competition was apt to have upon a utility. Applying Justice Cardozo's analysis to current conditions, one finds that competition has been supplanted by the dilemmas of demand growth and rising costs in the electric power industry. These modern developments are sufficient to support the "rational relation" presumption that a regulatory decision excluding advertising costs from operating expenses or even prohibiting categories of advertising is based on facts which warrant the conclusion that advertising is not a necessary element of utility service.

Under the rational relation standard categorical exclusion of promotional, institutional, or controversial subject advertising from operating expenses is constitutional economic regulation. It is reasonably in the public interest, given the serious problems with the price and supply of electric energy, and it represents a legislative judgment that a public electric utility does not need such advertising to accomplish its duty to serve consumers reliably at reasonable rates. Even a prohibition of some categories of utility advertising, as a method of regulation, has a "rational basis" sufficient to warrant the presumption that the prohibition does not violate due process. The ban could be overcome on appeal if a sufficient showing of facts by the utility rebutted the presumption of reasonableness.

All of the regulatory approaches represented by the state cases discussed above comport with fourteenth amendment standards of economic due process, thus, the conflict between the cases must be regarded as a matter of differing state law. Hence, the use of *West Ohio Gas* as authority for the conflicting state positions has no constitutional significance; however, the difference between the

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[98]Williamson v. Lee Optical Co., 348 U.S. at 489. The "rational relation" standard is not used when the governmental regulation affects noneconomic, personal rights which are "fundamental." If fundamental rights are in issue, the government regulation must meet a high level of scrutiny requiring a compelling government interest protected by a regulation which has no more impact on the personal right than necessary. Roe v. Wade, 410 U.S. 113 (1973) (right to privacy violated by law prohibiting abortion); Griswold v. Connecticut, 381 U.S. 479 (1965) (right to privacy violated by law prohibiting use of contraceptives); United States v. Guest, 383 U.S. 745 (1966) (right to travel freely between states). The personal nature of "fundamental rights" and their noneconomic quality would seem to preclude any application of high-level scrutiny fundamental rights protection to utility advertising.

Alabama and the Oklahoma or New York approaches is critical to the success of PURPA's advertising standard. The Alabama view that categorical presumptions about advertising as an operating expense is confiscatory precludes adoption of PURPA's promotional and "political" categories.[99] Other states which must review their regulation of electric utility advertising costs should remember that *West Ohio Gas* poses no constitutional impediment to the use of PURPA's categories as long as the current problems besetting the electric power industry persist.

B. First Amendment Protection for Electric Utility Advertising

In *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*,[100] the Supreme Court ruled that advertising which does "no more than propose a commercial transaction" has a degree of first amendment protection.[101] This new constitutional doctrine[102] places a significant limitation upon the trend for stricter state control of electric utility advertising.

Prior to *Virginia State Board*, first amendment law was based on a traditional, two-level formulation.[103] A few limited categories of speech content were held to have no first amendment value and hence were subject to complete governmental prohibition.[104] All

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[99]*See* note 73 *supra.*

[100]425 U.S. 748 (1976). The issue was the constitutionality of a statute which prescribed criminal penalties for pharmacists who advertised the prices of non-prescription drugs.

[101]Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations, 413 U.S. 376, 385 (1973), *quoted in* Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. at 762.

[102]For discussions of commercial speech, see Alexander, *Speech in the Local Marketplace: Implications of Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc. for Local Regulatory Power*, 14 SAN DIEGO L. REV. 357 (1977); Coase, *Advertising and Free Speech*, 6 J. LEGAL STUD. 1 (1977); Elman, *The New Constitutional Right to Advertise*, 64 A.B.A. J. 206 (1978); Pitofsky, *Beyond Nader: Consumer Protection and the Regulation of Advertising*, 90 HARV. L. REV. 661 (1977); Redish, *The First Amendment in the Marketplace: Commercial Speech and the Values of Free Expression*, 39 GEO. WASH. L. REV. 429 (1971); Comment, *The Right to Receive and the Commercial Speech Doctrine: New Constitutional Considerations*, 63 GEO. L.J. 775 (1975); Comment, *Prior Restraints and Restrictions on Advertising After Virginia Pharmacy Board: The Commercial Speech Doctrine Reformulated*, 43 MO. L. REV. 64 (1978); Comment, *First Amendment Protection for Commercial Advertising: The New Constitutional Doctrine*, 44 U. CHI. L. REV. 205 (1976); 31 VAND. L. REV. 349 (1978).

[103]Karst, *Equality as a Central Principle in the First Amendment*, 43 U. CHI. L. REV. 20, 33 (1975).

[104]The classic statement of these categories is in Chaplinsky v. New Hampshire, 315 U.S. 568 (1942):

> There are certain well-defined and narrowly limited classes of speech, the prevention and punishment of which have never been thought to raise any Constitutional problem. These include the lewd and obscene, the profane, the

other varieties of speech content were given a "preferred position"[105] which required that any state control over expression have as its purpose the protection of an "important," "significant," or "compelling" governmental interest,[106] and the means of control cannot impinge on expression any more than "necessary" to effect the state's purpose.[107] The high level of judicial scrutiny given to speech regulation was implemented to insure that the government's exercise of its police powers had minimal impact upon the free exchange of ideas, the primary value protected by the first amendment.[108] Because commercial speech was regarded as making negligible contributions to the social dialogue in ideas,[109] it was regarded as beyond the ambit of the first amendment.[110] Accordingly, regulations impinging on commercial speech were subject to low-level scrutiny.

Virginia State Board found a first amendment interest in the free exchange of commercial information, recognizing that individuals would be able to make better-informed economic decisions and thereby assure the efficient operation of commercial markets in

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> libelous, and the insulting or "fighting words"—those words which by their very utterance inflict injury or tend to incite an immediate breach of the peace. It has been well observed that such utterances are no essential part of any exposition of ideas, and are of such slight social value as a step to truth that any benefit that may be derived from them is clearly outweighed by the social interest in order and morality.

Id. at 571-72 (footnotes omitted).

[105]*See* Thomas v. Collins, 323 U.S. 516, 530 (1945).

[106]Erznoznik v. City of Jacksonville, 422 U.S. 205, 217 (1975); Grayned v. City of Rockford, 408 U.S. 104, 115 (1972); United States v. O'Brien, 391 U.S. 367, 376-77 (1968); NAACP v. Button, 371 U.S. 415, 438 (1963).

[107]For illustrations of the "means" test, see Shelton v. Tucker, 364 U.S. 479 (1960) (holding law requiring teachers in state schools to annually disclose all organizations joined violated the first amendment because the state's interest in assuring moral fitness in teachers could be protected by less drastic means); Schneider v. State, 308 U.S. 147 (1939) (holding ordinances prohibiting leaflet distribution invalid because the governmental interest—prevention of fraud, littering, and disorder—could be protected effectively by criminal penalties aimed at the undesirable consequences rather than at the leaflets).

[108]*E.g.*, Abrams v. United States, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting):

> [W]hen men have realized that time has upset many fighting faiths, they may come to believe even more than they believe the very foundations of their conduct that the ultimate good desired is better reached by free trade in ideas—that the best test of truth is the power of the thought to get itself accepted in the competition of the market, and that truth is the only ground upon which their wishes safely can be carried out.

[109]Valentine v. Chrestensen, 316 U.S. 52, 54 (1942).

[110]New York Times Co. v. Sullivan, 376 U.S. 254, 266 (1964) (distinguishing editorial advertisements from "purely commercial" speech); Breard v. Alexandria, 341 U.S. 622, 642 (1951); Martin v. City of Struthers, 319 U.S. 141, 142 n.1 (1943); Valentine v. Chrestensen, 316 U.S. 52, 54 (1942).

matching material resources with material needs.[111] Justice Blackmun's majority opinion accorded little weight to the "purely economic" interest of the advertiser,[112] an approach consistent with the "rational relation" standard the Court adopted for the regulation of economic activity under the fourteenth amendment due process clause.[113] The majority opinion instead focused upon the consumer audience's need for commercial information, which was said to be "indispensible" to consumer welfare.[114]

The Court carefully and clearly indicated that false and misleading commercial advertising has no first amendment value in the economic decision process and hence is unprotected speech.[115] Time, place, and manner regulations[116] of commercial speech were recognized as permissible, provided that such regulations were justified without reference to the content of the regulated speech, serve a significant governmental interest, and leave open ample alternative channels for communication of the information.[117]

The Court also stated that commercial speech has a lesser degree of first amendment protection than that accorded to non-commercial speech under traditional, high-level scrutiny.[118] The standard for the implementation of this lesser commercial speech protection, however, was not clearly distinguished from that applied in non-commercial, high-level contexts. *Virginia State Board* used a balancing test to determine whether Virginia's restriction on drug price advertising had either a "significant" governmental interest to protect or a sufficiently narrow means of regulation[119] to effect the

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[111]425 U.S. at 765.

[112]*Id.*

[113]*See* notes 97-100 *supra* and accompanying text.

[114]425 U.S. at 765.

[115]*Id.* at 771.

[116]Time place, and manner restrictions have been recognized by the Court as constitutional regulation, if conduct is sought to be controlled and the impact on the exercise of speech is incidental and content-neutral. *E.g.*, Grayned v. City of Rockford, 408 U.S. 104, 116-17 (1972).

[117]425 U.S. at 771.

[118]The Court said:

> In concluding that commercial speech enjoys First Amendment protection, we have not held that it is wholly undifferentiable from other forms. There are commonsense differences between speech that does "no more than propose a commercial transaction," . . . and other varieties. Even if the differences do not justify the conclusion that commercial speech is valueless, and thus subject to complete suppression by the State, they nonetheless suggest that a different degree of protection is necessary to insure that the flow of truthful and legitimate commercial information is unimpaired.

Id. at 771-72 n.24.

[119]Virginia asserted that the interests its regulation was intended to protect were the level of professionalism among state phramacists, which the severe price competi-

protection. Because the Virginia law was clearly insufficient under this balancing test, it is not certain what effect the difference between the commercial speech standard and the traditional high-level standard will have upon the facts of closer cases.[120] The high value assigned in *Virginia State Board* to the advertising audience's ability to evaluate commercial messages for itself, without "paternalistic" state censorship,[121] will probably be the critical factor in future cases. Given the repugnance of censorship to first amendment values, most commercial advertising prohibitions will fall. Time, place, and manner restrictions will generally withstand challenge due to the availability of other forums for the speech.

In assessing *Virginia State Board*'s impact upon the regulation of electric utility advertising, an initial issue is which, if any, of the content categories used in the new regulatory approach are protected by the non-commercial, strict first amendment standard rather than the weaker commercial standard. Clearly, the resolution of this issue does not depend on whether a category of utility advertising proposes a commercial proposition. The Court's rationale for its commercial/non-commercial differential in the context of the first amendment indicates that the test must be the relative value of the content in each category of advertising.

The issue in *Virginia State Board* was whether speech which did no more than propose a commercial transaction such as "I will sell

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tion engendered by drug price advertising would allegedly erode, and the health of its citizens, which would be endangered by the lowered professional standards. The means, of course, was prohibition of all non-prescription drug price advertising. *Id.* at 776.

[120]The Court's subsequent commercial speech cases have not significantly refined the standard for *Virginia State Board's* balancing test. In Linmark Assoc., Inc. v. Willingboro, 431 U.S. 85 (1977), the town ordinance prohibiting posting of "For Sale" signs to avoid "white flight" from neighborhoods on the verge of integration was as unreasonable in its means as Virginia's law on drug prices.

Court cases applying the commercial speech doctrine to advertising by professionals are of marginal relevance to situations in which advertising of a product like electricity is restricted. The issue in the professional advertising cases was, fundamentally, whether services not readily subject to price standardization could be advertised without misleading the consumer. *See* Bates v. State Bar of Ariz., 433 U.S. 350 (1977) (holding regulation barring advertisement of "routine" legal services unconstitutional).

[121]The Court stated:

> [O]n close inspection it is seen that the State's protectiveness of its citizens rests in large measure on the advantages of their being kept in ignorance. . .
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> . . . .
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> . . . There is, of course, an alternative to this highly paternalistic approach. That alternative is to assume that this information is not in itself harmful, that people will perceive their own best interests if only they are all well enough informed, and that the best means to that end is to open the channels of communication rather than to close them.

425 U.S. at 769-70.

you the X prescription drug at the Y price"[122] was "so removed from any 'exposition of ideas' . . . that it lacks all protection."[123] The Court thus considered commercial speech's position under the first amendment in terms of the traditional content test. In holding that the drug advertisement was protected speech, the Court recognized its value as information in the consumer's decision process and in the general allocation of society's resources.[124] This value, based on the advertising's content, was not perceived as being directly related to "the exposition of ideas." The only ideational value which the Court recognized in this advertising was indirect, derived from its use in the aggregate: "[I]f [the free flow of commercial information] is indispensable to the proper allocation of resources in a free enterprise system, it is also indispensable to the formation of intelligent opinions as to how that system ought to be regulated or altered."[125]

The relatively low ideational value of information "as to who is producing and selling what product, for what reason, and at what price"[126] would seem to be the basis for assigning such information lower protection under the first amendment.[127] The primary value of

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[122]*Id.* at 761-62.

[123]*Id.* at 762.

[124]*Id.* at 765.

[125]*Id.*

[126]*Id.*

[127]The Court has avoided an express formulation of the commercial/non-commercial first amendment protection differential in these terms, notwithstanding *Virginia State Board*'s initial use of an ideational content test, *see* note 125 *supra* and accompanying text, in its commercial speech discussion. In the most recent commercial speech case, Friedman v. Rogers, 47 U.S.L.W. 4151, 4154 (U.S. 1979) (holding, inter alia, that a Texas ban on the use of trade names in advertisements of optometrical services was permissible regulation of misleading commercial speech), the Court relied instead upon *Virginia State Board*'s recognition that commercial speech needs a lesser degree of protection from regulation because it is objective and more readily verifiable than non-commercial speech and because it is less apt to be inhibited by government control due to the resilience of the commercial advertiser's economic motive. 425 U.S. at 771-72 n.24.

But these two characteristics of commercial speech relied upon in *Friedman* are significant in the protection differential not so much because they define what commercial speech is as because they indicate what it is not:

> Ideological expression, be it oral, literary, pictorial, or theatrical, is integrally related to the exposition of thought—thought that may shape our concepts of the whole universe of man. Although such expression may convey factual information relevant to social and individual decisionmaking, it is protected . . . whether or not it contains factual representations and even if it includes inaccurate assertions of fact. . . . "Under the First Amendment there is no such thing as a false idea" . . . .
>
> Commercial price and product advertising differs markedly from ideological expression because it is confined to the promotion of specific goods or services. The First Amendment protects the advertisement because of the "information of potential interest and value conveyed," rather than

this information is its indispensability to individual and aggregate economic activity, a value which deserves first amendment recognition, albeit to a lesser degree.

Whether commercial information appears in an advertisement proposing a product sale or in some other form should not alter the information's first amendment value. As a matter of doctrine, the commercial proposition formula functions only to indicate the type of speech which has the commercial level of ideational value and does not limit the commercial standard's reach to speech containing proposals to sell. The types of speech which are not commercial were identified in *Virginia State Board*: "[T]he question whether there is a First Amendment exception for 'commercial speech' is squarely before us. Our pharmacist does not wish to editorialize on any subject, cultural, philosophical, or political. He does not wish to report any particularly newsworthy fact, or to make generalized observations even about commercial matters."[128]

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because of any direct contribution to the interchange of ideas.
425 U.S. at 779-80 (Stewart, J., concurring) (citations omitted).

The Court's apparent preference to formulate the commercial/non-commercial first amendment distinction in terms of commercial speech's greater amenability to regulation rather than its low ideational content seems to arise from a desire to limit the first amendment's involvement in commercial matters, for two reasons. First, the Court has indicated that it wants to avoid any unnecessary first amendment inhibition of the governmental power to regulate economic conduct: "[W]hile the First Amendment affords [commercial] speech a 'limited measure of protection,' it is also true that 'the State does not lose its power to regulate commercial activity deemed harmful to the public whenever speech is a component of that activity.'" *Friedman*, 47 U.S.L.W. at 4154 n.9 (quoting Ohralik v. Ohio State Bar Ass'n, 436 U.S. 447, 456 (1978)). Second, the Court may be reluctant to use a formulation emphasizing the relation of the commercial speech standard to the traditional first amendment protection lest the traditional doctrine be weakened by association: "To require a parity of constitutional protection for commercial and non-commercial speech alike could invite dilution, simply by a levelling process, of the force of the Amendment's guarantee with respect to the latter kind of speech." 436 U.S. at 456. The Court's desire to avoid diluting either traditional first amendment protection of "the exposition of ideas" or governmental power to regulate economic activity explain both the retention of a commercial/non-commercial distinction in first amendment law and the formulation of that distinction in terms of commercial speech's objective, more regulable characteristics. Commentators agree that the constitutionality of commercial speech regulation is a matter properly resolved in terms of the traditional, ideational-content first amendment doctrine. *Compare* Note, *Yes, FTC, There Is a Virginia: The Impact of Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc. on the Federal Trade Commission's Regulation of Misleading Advertising*, 57 B.U.L. REV. 833, 847-48 (1977) (asserting that commercial speech is of same value to society as any other category of speech and that its suppression must be justified under traditional first amendment principles rather than under "degree of protection" doctrine) *with* Comment, *First Amendment Protection for Commercial Advertising: The New Constitutional Doctrine*, 44 U. CHI. L. REV. 205, 222-34 (1976) (criticizing objective characteristics of commercial speech as bases for defining commercial speech and concluding only workable definition is the lower first amendment value of commercial speech).

[128] *Id.* at 760-61.

This evaluation of *Virginia State Board* indicates that promotional electric power advertisements, which contain information about the uses of electricity, its cost, and its general value as a product, are commercial speech. Conservation advertising provides the public with information on the characteristics of electricity's use, but it also generally contains an element of editorial opinion on the broader subject of energy supply and the ramifications which energy use has for society at large. Such information, hence, has ideational content which exceeds the commercial speech level. Consumer information advertising, to the extent that it does no more than inform the public of the ways in which a commercial relationship with a utility can be started or maintained or of the prices charged for electricity, is commercial speech. Such advertising, however, often provides information about safety precautions or emergency procedures which has significance apart from the purchase or sale of electricity. This variety of consumer information advertising would be protected by the non-commercial level of first amendment scrutiny. "Controversial subject" advertising is editorial in nature, consisting primarily of ideas and opinions, and hence is non-commercial speech.

Institutional "image"[129] advertising has been recognized as having an element of commercial speech, in an indirect manner.[130] In effect, "image" advertising can often operate as an implicit proposal of a commercial transaction. An implicit proposal of a product sale, however, does not make speech commercial. The proper test for commercial speech is whether the content of the advertising has no more than commercial value. The "institutional" category of utility advertising usually contains information which is "newsworthy," without any commercial import—information on anti-pollution practices or community assets, for example. Even institutional advertising which amounts to no more than an appeal for public sympathy

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[129]The FTC has defined corporate "image" advertising as:

> [A]dvertising which describes the corporation itself, its activities, or its policies, but does not explicitly describe any products or services sold by the corporation. Within the wide range of subjects covered in image ads are descriptions of the corporation's behavior in such diverse areas as research and development and activities and programs reflecting a sense of social responsibility towards, for example, the community or the environment.

FTC, *Statement of Proposed Enforcement Policy by the Staff of the FTC Regarding Corporate Image Advertising* 2 (Dec. 4, 1974), *reprinted in* SUBCOMM. ON ADMIN. PRACTICE & PROC. OF THE SEN. COMM. ON THE JUDICIARY, SOURCEBOOK ON CORPORATE IMAGE AND CORPORATE ADVOCACY ADVERTISING 1488-89 (1978).

[130]FTC, *Statement of Proposed Enforcement Policy by the Staff of the FTC Regarding Corporate Image Advertising* 4-10 (Dec. 4, 1974), *reprinted in* SUBCOMM. ON ADMIN. PRACTICE & PROC. OF THE SEN. COMM. ON THE JUDICIARY, SOURCEBOOK ON CORPORATE IMAGE AND CORPORATE ADVOCACY ADVERTISING 1490-96 (1978).

does more than merely give information about a product, although its value as an idea may not be appreciably greater than commercial speech. Hence, even the least informative "image" advertisement is non-commercial and is protected by the traditional strict first amendment scrutiny.

The mode of regulation which divides advertising expenses between power customers and stockholders appears on its face not to violate the first amendment. It does not prohibit any variety of advertising. Its nature as a means of regulation is economic in purpose and effect.[131] Complete prohibition of a class of electric utility advertising, however, must be subjected to serious first amendment scrutiny. If institutional, "controversial subject," conservation, or consumer information advertising were prohibited, traditional first amendment strict scrutiny would be required. Promotional advertising would be protected by the *Virginia State Board* standard.

Whether a prohibitory mode of regulation could withstand a first amendment challenge would depend primarily upon whether the state could demonstrate an interest sufficiently important to justify prohibition. The prohibition would then have to be shown to be sufficiently narrow in scope to protect the state's interest adequately without unnessarily infringing on protected speech. A sufficient justification for a prohibition would have to be more than elimination of a utility practice which was not an essential element of electric service. The regulatory rationale would have to be based on the threat which the prohibited advertising would ultimately pose to the utility's ability to meet power demands or to the consumer's ability to pay for the service.[132] The retarding of demand

[131]One ramification of this type of regulation, however, recently provoked a first amendment claim in Consolidated Edison Co. v. Public Serv. Comm'n, 63 A.D.2d 364, 407 N.Y.S.2d 735 (1978). After receiving requests that consumer groups be allowed to include anti-nuclear power material in Consolidated Edison's bill mailings as a response to the utility's sending its customers pro-nuclear power information with their bills, the New York Public Service Commission ordered utilities not to send any material concerning controversial public policy matters with bills. The trial court held that the Commission's order violated the first amendment, but the judgment was reversed on appeal. The appellate court held that the Commission order was a constitutional exercise of the regulatory power to determine which utility expenses should be borne by stockholders rather than consumers. The court found that the utility's use of bill mailings for its controversial advertising was subsidized by the consumers who were charged the postage costs. The appellate court's reasoning is persuasive. The bill insert regulation was a time, place, and manner regulation whose purpose was primarily economic and, beyond its abstract "controversial subject" category, was content neutral. The effect on speech, whether it be characterized as commercial or political, was incidental to the economic purpose of the regulation, and the regulation left open ample alternative channels for the utility to put the information before the public, at stockholder expense.

[132]A critical need for reduction in the growth of electric demand was asserted as the interest underlying New York's prohibition of promotional advertising in Con-

and of cost increases for electric power, both for the utility producing it and for the consumer buying it, would seem to be a sufficient interest to meet first amendment standards. Under either the "compelling" or the "significant" standard, the state would have an important interest to protect.

The critical issue thus becomes the propriety of the prohibition as a means to a justified end. A prohibition of promotional advertising would be difficult to justify as an efficacious method of reducing power demand or consumption, primarily because the prohibition is under-inclusive in removing the inducements for consumers to use electrically-powered equipment.[133]

Promotional advertising prohibitions would also prevent the utility from using advertising which would help reduce one dimension of its difficulties under the current conditions—its declining load factor. Promotion of non-peak electric use would aim at increasing utility revenues without significantly increasing the need for new plant investment. A regulatory commission could constitutionally determine that such advertising was of little effect and hence should not be charged to customers, but in order to justify a prohibition the commission would have to show that the advertising either excessively contributed to the peak load or was so effective at en-

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solidated Edison Co. v. Public Serv. Comm'n, 63 A.D.2d 364, 407 N.Y.S.2d 735 (1978). The court held that the promotional advertising ban did not violate the first amendment, due to what it deemed to be a "compelling" finding of the New York Public Service Commission:

> [P]romotional advertising will increase the use of electricity causing spiraling price increases due to the fact that present rates do not cover the marginal cost of new capacity; that such advertising provides misleading signals that energy conservation is unnecessary; and that additional usage will increase the level of dependence on foreign sources of fuel oil . . . .

Id. at 366, 407 N.Y.S.2d at 738.

The court took its "compelling" state interest test from First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765 (1978) (holding law providing criminal penalties for corporations contributing money to interest groups promoting one side of a public referendum violated the first amendment). The *Bellotti* decision concerned political speech, and the *Consolidated Edison;* opinion's use of a traditional, strict scrutiny test in a commercial speech context was error. The use of a standard which was more rigorous than the case required made little difference in *Consolidated Edison;* the court summarily accepted the Commission's "compelling" finding without any attempt to balance the utility's commercial speech interest with the prohibitory mode of regulation to see if the Commission could obtain substantially similar results from a less restrictive type of regulation.

[133]An under-inclusive regulation does not reach all the causes of the effect it is intended to prevent. For example, a regulation intended to stop the sale of whiskey is under-inclusive if it prohibits only Scotch whiskey. A regulation intended to stop the sale of whiskey is over-inclusive if it prohibits the sale of all liquor. The classic discussion of under-/over-inclusive regulation is in Tussman & tenBroek, *The Equal Protection of the Laws,* 37 CAL. L. REV. 341, 344-53 (1949).

couraging off-peak load that it significantly reduced the utility's fuel supplies. It is unlikely that such effects could be demonstrated.

The single significant justifications for a prohibition of promotional electric utility ads is that they give consumers a false impression that power is in abundant supply and that conservation is a principle to be observed by others.[134] Advertising which does not expressly assert that conservation is unnecessary, however, should not be prohibited if it provides consumers with information about a particular use of electricity. The value to consumers in the express content of such advertising justifies its free communication despite any implicit misleading message it may contain about the need to conserve. The ill-effects of such an implicit message would seem to be properly countered, under *Virginia State Board*, by consumer judgment rather than censorship.[135]

Consumer groups have suggested another rationale for prohibition of non-commercial advertising. If the advertising is done at stockholder expense, the reduction in dividends to investors caused by the diversion of earnings to pay for the advertising reduces the utility's ability to attract capital and forces it to obtain financing for new facilities to meet demand growth by borrowing at inflated interest rates.[136] The effect of stockholder-financed advertising on utility interest expenses, with its consequent effect on utility rates and the fiscal health of the utility, would have to be severe in order to justify a prohibition on that basis alone. It is highly unlikely that utility managements would use stockholder-financed advertising so extensively that the dividend rates on utility stock would be reduced

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[134]False or misleading advertising is within the jurisdiction of the FTC, which is empowered to police an "unfair or deceptive act or practice in or affecting commerce . . . ." 15 U.S.C. § 52(b)(1) (1976). The FTC, however, has expressed a reluctance to involve itself with deceptive or misleading electric utility advertising. In response to a petition to, inter alia, take enforcement action against a utility ad alleged to be misleading, the FTC stated: "If we were to question the representations made, we would be inextricably drawn into the complicated area of setting utility rates." FTC, *Corporate Image Advertising: Memorandum to the Commission from Staff of Division of National Advertising* 141 (Mar. 18, 1974), *reprinted in* SUBCOMM. ON ADMIN. PRACTICE & PROC. OF THE SEN. COMM. ON THE JUDICIARY, SOURCEBOOK ON CORPORATE IMAGE AND CORPORATE ADVOCACY ADVERTISING 1149 (1978).

[135]*See* note 121 *supra* and accompanying text for discussion of *Virginia State Board*'s preference for consumer judgment rather than censorship.

[136]*Ad Campaigns*, *supra* note 9, at col. 5 (referring to remarks of F. Wiecking, executive director of Indiana's Citizens Action Coalition):

> Wiecking also said the utility distinction between stockholder-paid ads and those paid out of rates is "in many ways a paper argument." Using stockholder funds will reduce the utility's equity income, he said, which in turn makes it more difficult and expensive for the firm to borrow money. Those higher capital expenses eventually result in higher rates, he said.

to the point that the utility's ability to obtain equity capital would be severely damaged. If the outlays for stockholder-financed advertising did approach that point, the stockholders would undoubtedly remedy the situation themselves. If the stockholders failed to halt the imprudent outlays, a regulatory order limiting the amount of earnings which could be spent on advertising would be preferable to a complete prohibition addressed directly to the advertising.

Under the first amendment, whether the level of protection is commercial or traditional strict-level, the prohibitory mode of advertising regulation is seriously suspect. The inefficacy and paternalistic nature of promotional advertising prohibitions and the availability of less restrictive alternatives to either commercial or non-commercial content prohibitions are factors which made the prohibitory mode of regulation appear to violate the first amendment.

V. CONCLUSION

The history of state regulation of investor-owned electric utilities has a certain quality of anomaly, a product of the unique circumstances in which the nation's electric power industry developed. Due to technological improvements which permitted consistent economies of scale to be achieved in the production of an energy form that became increasingly indispensable, electric prices fell while others rose. Under such conditions it was reasonable to promote the use of electricity and have the promotion paid for by the consumer. *West Ohio Gas*, promulgated a year after substantive economic due process was abandoned by the Supreme Court, cannot be read to dilute the state's police power under the "rational relation" due process standard, yet for years it has been relied upon by state decisions holding that electric utility advertising was a proper expense for consumers to bear. As long as electricity was becoming less costly, the state policies toward electric power advertising were reasonable and their reliance on *West Ohio Gas* to support the practice of charging the consumer for advertising fostering utility expansion was not misplaced.

Circumstances have changed. Growth is no longer profitable for either the electric utilities or cheaper for their customers, yet it also seems inescapable. It is no longer reasonable to have consumers pay the cost of promotional or "image" advertising by electric utilities, if that advertising contributes to the need for new utility plants or encourages uneconomical and wasteful electric consumption. Many states have recognized this, and have exercised their power under the rational relation standards of due process to exclude nonessential advertising costs from electric rates. PURPA will force states

adhering to the traditional standard to re-evaluate their policies. In considering whether the traditional approach should prevail over PURPA, these states should recognize that *West Ohio Gas* does not constitutionally prevent them from using content categories to determine which advertising expenses are charged to consumers.

At almost the same time that it became uneconomical to promote electric consumption, the value of commercial speech to society was recognized in *Virginia State Board*, which brought commercial speech within the protection of the first amendment. As a matter of public policy, it is certainly desirable to encourage consumers to avoid unnecessary power use and to reduce nonessential utility advertising expenditures. However, the use of prohibitions of utility advertising to achieve these policy objectives is unnecessary and unreasonable. Economic regulation in most cases would seem to be sufficient to discourage improvident advertising. And under the standard of protection afforded advertising either by *Virginia State Board* or traditional strict scrutiny, a balancing of the legitimate need for and the efficacy of a prohibition on a category of electric utility advertising would appear to put prohibitory modes of regulation outside the first amendment.

MICHAEL J. MCMAHON

Recent Development

Antitrust—PRICE SQUEEZE—A vertically integrated utility's imposition of wholesale rates that exceeded its retail rates held to be an exclusionary act in violation of antitrust laws. *City of Mishawaka v. American Electric Power Co.*, Nos. S74-72, S75-210, S77-209 (N.D. Ind. Jan. 30, 1979).

The United States District Court for the Northern District of Indiana, in *City of Mishawaka v. American Electric Power Co.*,[1] decided that a large, investor-owned, vertically integrated[2] electric utility had violated antitrust laws. Indiana & Michigan Electric Co. (I & M), a subsidiary of American Electric Power Co., engaged in a series of exclusionary acts[3] which were forcing small Indiana and Michigan municipal utilities out of the retail electric power business. The decision particularly condemned I & M's exclusionary practice of charging its municipal customers higher wholesale rates than the retail rates offered to its industrial and fringe customers.[4] Such rate tactics are commonly called price squeezes[5] because the investor-owned utility's excessive wholesale rates make it economically im-

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[1]Nos. S74-72, S75-210, S77-209, (N.D. Ind. Jan. 30, 1979), *remanded*, City of Mishawaka v. Indiana & Mich. Elec. Co., 560 F.2d 1314 (7th Cir. 1977), *cert. denied*, 436 U.S. 922 (1978). For a more complete discussion of the Seventh Circuit decision, see notes 20-21 *infra* and accompanying text.

[2]A vertically integrated electric utility is one that performs on two or more of the following levels: generation, which is the production of electricity; transmission, which is the transport of power over long distances; and distribution, which is the process of dividing power among customers on the wholesale or retail level.

[3]The district court decided that a public utility's imposition of unjust and unreasonable wholesale rates which exceeded its retail rates and the utility's threats to withdraw from the wholesale market and to impose limits on its service obligations, constituted exclusionary conduct, which demonstrated a violation of § 2 of the Sherman Act. Nos. S74-72, S75-210, S77-209, slip op. at 18.

[4]*Id.*

[5]Although the term "price squeeze" has been used in many different contexts, in this Recent Development it will refer to the situation in which a vertically integrated company distributing a service on both the wholesale and retail levels, with a monopoly on the wholesale level, charges an excessive wholesale price so that the company's wholesale customers cannot compete with the prices offered by the company on the retail level. "Price squeeze" has also been used to characterize the situation in which municipal and cooperative utilities must absorb the costs of a new wholesale rate because they cannot pass these costs onto the consumer immediately. *Hearings on Regulatory Reform—Vol. VI Before the Subcomm. on Oversight & Investigations of the House Comm. on Interstate & Foreign Commerce*, 94th Cong., 2d Sess. 642-45 (1976) (statement of Wallace Duncan).

possible for the municipal utilities and rural cooperatives, which buy wholesale from the large utility, to offer retail rates that are competitive with those offered by the large utility to industrial and fringe customers.

During the last decade, a growing number of municipal utilities and rural electric cooperatives have initiated massive administrative and legal assaults against many large, privately owned, vertically integrated utilities which have allegedly attempted to monopolize the retail sale and distribution of electric power by exerting price squeezes on smaller systems that depend on the large system for wholesale power.[6] Initially, the Federal Power Commission (FPC), now the Federal Energy Regulatory Commission,[7] refused to consider the price squeeze allegations in reviewing wholesale rate requests made by large utilities on the grounds that the agency only had jurisdiction over wholesale rates and, therefore, could not examine a dual rate price structure which involved both retail and wholesale rates.[8] Moreover, by filing numerous procedural challenges, the large investor-owned utilities temporarily thwarted a number of antitrust suits filed by the small municipal and cooperative systems.[9] Yet, recent judicial decisions, including *American Electric Power Co.*, indicate a genuine effort to combat alleged price squeeze abuses by synthesizing antitrust and regulatory functions and policies to preserve competition on the retail distribution level of the electric power industry.[10]

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[6]City of Mishawaka v. Indiana & Mich. Elec. Power Co., 560 F.2d 1314 (7th Cir. 1977), *cert. denied*, 436 U.S. 922 (1978); City of Mishawaka v. American Elec. Power Co., Nos. S74-72, S75-210, S77-209 (N.D. Ind. Jan. 30, 1979); City of Groton v. Connecticut Light & Power Co., 456 F. Supp. 360 (D. Conn. 1978); City of Shakopee v. Northern States Power Co., No. 4-75-591 (D. Minn. Oct. 19, 1976).

[7]Created by Congress in 1920 to regulate the construction of hydroelectric projects, the FPC in 1935 was empowered to approve the transmission and sale of electric power in interstate commerce by setting just and reasonable rates. Federal Power Act of 1935, § 206(a), 16 U.S.C. § 824e(a) (1976). The Supreme Court held in 1964 that the FPC's ratemaking authority extends to the interstate sale of wholesale power. FPC v. Southern Cal. Edison Co., 376 U.S. 205, 210 (1964). In 1977, Congress transferred the ratemaking authority to the Federal Energy Regulatory Commission (FERC). Department of Energy Organization Act of 1977, Pub. L. No. 95-91, § 402, 91 Stat. 565 (1977) (to be codified in 42 U.S.C. § 7101).

[8]Southern Cal. Edison Co., 50 F.P.C. 836 (1973).

[9]*See* cases cited note 6 *supra*.

[10]*See generally* Meeks, *Concentration in the Electric Power Industry: The Impact of Antitrust Policy*, 72 COLUM. L. REV. 64, 75-76 (1972). *But see* Hale & Hale, *Competition or Control VI: Application of Antitrust Laws to Regulated Industries*, 111 U. PA. L. REV. 46 (1962). Judicial efforts to coordinate regulatory and antitrust policies and functions were necessary because the Federal Power Act, as interpreted by the Supreme Court, left wheeling to the voluntary arrangements of different utilities and thereby foreclosed competition among wholesale distributors in supplying municipal

I. History of Efforts to Treat Price Squeeze Abuses

The Supreme Court initiated this synthetic effort in *FPC v. Conway Corp.*,[11] wherein the Court decided that the FPC had the power to consider and eliminate price squeeze abuses in evaluating wholesale rate requests.[12] The case involved nine Arkansas municipal and cooperative utilities which wanted the FPC to consider price squeeze allegations in approving the wholesale rates of a vertically integrated utility. The Court flatly rejected the FPC's argument that the agency lacked jurisdiction over dual rate abuse. Relying on section 205(b)[13] of the Federal Power Act which prohibits any unreasonable discrimination in rates with respect to any sale subject to Commission jurisdiction, the Court decided that, if a wholesale rate is in any way responsible for an anticompetitive difference between the wholesale and retail rates charged by a public utility, then the agency has the power to design a remedy[14] under section 206(a).[15] The Court indicated that the agency has the power

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and cooperative customers. Otter Tail Power Co. v. United States, 410 U.S. 366, 374 (1973) (ironically, a vertically integrated utility unsuccessfully contended that Congress intended wheeling matters, including anticompetitive refusals to wheel power to retail competitors, to be exempt from antitrust review); *accord*, Richmond Power & Light Co. v. FERC, 574 F.2d 610, 620 (7th Cir. 1978). Briefly defined, wheeling is the transmission of electric power by one utility to another utility over a third firm's lines. If wheeling were compulsory, investor-owned utilities theoretically could compete with themselves to supply municipal and cooperative customers and thereby reduce the opportunity for price squeeze abuses. Although Congressional subcommittees have examined numerous pieces of legislation that would allow FERC to compel wheeling in the public interest, Congress has never voted on these proposals. *See Hearings on Electric Utility Rate Reform and Regulatory Improvement Pursuant to H.R. 12461, H.R. 2633, H.R. 2650, H.R. 6696, H.R. 10869, H.R. 11449, H.R. 11475, H.R. 12848, H.R. 12872 Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce*, 94th Cong., 2d Sess., pt. 1, 37, 127 (1976) [hereinafter cited as *Hearings Pursuant to H.R. 12461*]; Hearings on Electric Utility Rate Reform Pursuant to S. 1666, S. 2208, S. 2502, S. 2747, S. 3011, S. 3310, S. 3311 Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 129-30 (1976).

[11]426 U.S. 271 (1976).

[12]*Id.* at 277.

[13]Federal Power Act of 1935, § 205(b), 16 U.S.C. § 824d(b) (1976). Section 205(b) provides:

> No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

[14]426 U.S. at 277.

[15]Federal Power Act of 1935, § 206(a), 16 U.S.C. § 824e(a) (1976). Section 206(a) provides:

> Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded,

under section 206(a) to reduce the wholesale rates to the lowest just and reasonable level in order to remove the price squeeze effects caused by the utility's wholesale rates.[16] As a result of *Conway*, FERC (formerly the FPC) has the clear responsibility to consider price squeeze allegations and to prevent such tactics if the price squeeze is found to be anticompetitive.

Although *Conway* represented a significant step in preventing anticompetitive dual rate practices, the administrative process did not eliminate all of the possible sources of price squeeze abuses or remedy all of the effects of past rate tactics. In fact, the agency's method of rate review provides an environment conducive to discriminatory rate practices by vertically integrated utilities.[17] According to FERC procedures, a utility can request and collect any number of wholesale rate increases before review of the first request is completed.[18] Municipals and rural cooperatives openly contend that regulatory delay in reviewing wholesale rates as well as the filing of rate requests in rapid succession (pancaking) leaves the small utilities vulnerable to price squeeze tactics exerted by the investor-owned systems. Although a refund may be granted ultimately for any unjust and discriminatory rate collected by the large privately-owned systems, the municipals and cooperatives argue that they may not be in existence by the time rate review is complete.[19]

Aware of the agency's limited remedial powers under *Conway*, the Seventh Circuit Court of Appeals in *City of Mishawaka v. Indiana & Michigan Electric Co.*[20] ostensibly approved the use of the antitrust laws to alleviate dual rate abuses by holding that the agency did not have exclusive jurisdiction, which would exempt price squeeze tactics from antitrust review by the courts,[21] or primary

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observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affected such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

[16]426 U.S. at 279.

[17]City of Mishawaka v. Indiana & Mich. Elec. Co., 560 F.2d 1314, 1324-25 (7th Cir. 1977), *cert. denied*, 436 U.S. 922 (1978); *see* City of Mishawaka v. American Elec. Power Co., Nos. S74-72, S75-210, S77-209, slip op. at 39 (N.D. Ind. Jan. 30, 1979).

[18]City of Mishawaka v. Indiana & Mich. Elec. Co., 560 F.2d 1314, 1325 (7th Cir. 1977), *cert. denied*, 436 U.S. 922 (1978).

[19]*Id.*

[20]560 F.2d 1314 (7th Cir. 1977), *cert. denied*, 436 U.S. 922 (1978).

[21]560 F.2d at 1321. In many cases, Congressional statutes provide that certain matters are exempted from antitrust review and are within the sole jurisdiction of an agency. *See* Note, *Regulated Industries and the Antitrust Laws: Substantive and Pro-*

jurisdiction, which would preempt antitrust litigation until the agency had reviewed the wholesale rate requests for their justness and reasonableness.[22] The Seventh Circuit's refusal to grant the FPC ex-

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cedural Coordination, 58 COLUM. L. REV. 673, 679-81 (1958). If statutory authority is silent, the task of deciding whether an issue is within the exclusive jurisdiction of an agency is more difficult. The federal courts have provided some exemptions by finding that a regulatory act has impliedly repealed the antitrust act to the extent that the regulatory and antitrust acts are in conflict. The courts have indicated that they will imply such exemptions only if a plain repugnancy exists between the antitrust and regulatory statutes and that a mere conflict in standards between the two acts is not sufficient. 560 F.2d at 1321 n.8. In determining whether a "plain repugnancy" exists, the federal courts generally ask if antitrust immunity is necessary for the regulatory act to be effective. Gordon v. New York Stock Exch., Inc., 422 U.S. 659, 683 (1975) (SEC case); Silver v. New York Stock Exch., Inc., 373 U.S. 341, 357 (1963) (SEC case). *See also* 560 F.2d at 1321. In light of the Supreme Court's holding in *Conway*, the appellate court determined that the FPC's jurisdiction to approve wholesale rates and to consider price squeezes in setting those rates could not immunize a vertically integrated utility's anticompetitive conduct from antitrust laws prohibiting dual rate abuses. The *Mishawaka* court held that antitrust immunity was not necessary to the regulatory process because the price squeeze was external to that process. *Id.* In other words, the application of antitrust principles to the price squeeze would not interfere greatly with the FPC's ratemaking authority. *Id.* The court stated that the anticompetitive rate structure involved retail rates which are the jurisdiction of state regulatory agencies and not the FPC. *Id.* The court also explained that the FPC's power to set wholesale rates would not be disturbed if the municipals only sought relief for past damages and injunctive relief against future abuses. To substantiate this point, the Seventh Circuit Court of Appeals quoted an FPC order recognizing that the agency could only examine pending rate requests for price squeezes and could not look at past schedules for price squeeze abuses, grant damages for abuses, or issue orders enjoining future abuses. *Id.* It thus determined that the FPC did not have exclusive jurisdiction over this issue.

[22]Primary jurisdiction allows the courts to refer certain issues to the federal agency before the court reviews the matter. Primary jurisdiction may be appropriate in order to promote uniformity of result. *Id.* at 1322. *See generally* 3 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 19.01 (1958 & Supp. 1965). In assessing whether uniformity of the regulatory scheme required the district court to give the FPC primary jurisdiction over antitrust conduct, the *Mishawaka* court stated: "The antitrust and regulatory regimes accommodate and supplement each other in order to prove full protection from anti-competitive practices." 560 F.2d at 1323. Therefore, *Mishawaka* decided that the federal courts should apply antitrust laws only "to the extent that antitrust claims are not within the reach of the regulatory agency's supervision." *Id.* at 1324. The court held that antitrust review in this case would not violate this standard because the relief sought by the plaintiffs would not significantly conflict with or improperly preempt the FPC's supervision of a vertically integrated utility's wholesale rates even where the agency could consider anticompetitive price squeezes in setting wholesale rates. *Id.* at 1323-24. According to the court, the Federal Power Act does not necessarily prevent the application of the antitrust laws where the FPC has the power to consider antitrust factors. The court also explained that the agency had only limited remedial powers. The Commission cannot eliminate a price squeeze by raising retail rates because such rates can only be adjusted by the states. *Id.* at 1323. Moreover, the *Conway* remedy of reducing wholesale rates to remove the price squeeze is necessarily

clusive or primary jurisdiction over price squeeze claims allowed the district court on remand, in *American Electric Power Co.*, to offer the first definitive statement on the application of antitrust laws to price squeeze abuses in the electric power industry.

II. An Overview of *American Electric Power Co.*

American Electric Power Co. involved an antitrust suit filed by ten Indiana and Michigan municipalities against I & M, a vertically integrated, investor-owned utility, and two other defendants.[23] I & M sells power on the wholesale level to the plaintiff municipalities as well as on the retail level to its own customers. The cities alleged that I & M intentionally monopolized the retail sale and distribution of electricity by engaging in a number of exclusionary acts,[24] including a price squeeze, which were in violation of section 2 of the Sherman Act.[25]

In analyzing the case, the district court stated that a section 2 violation required proof that I & M not only had monopoly power in a relevant market, but also had the general intent to abuse that power.[26] The district court decided that I & M had two forms of monopoly power.[27] First, the defendant possessed a monopoly over

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limited in that the FPC cannot set the rates below the level needed to recover costs. *Id.*

In addition, the federal courts can give the agency primary jurisdiction if the agency would advance the court's fact-finding capacity or aid the court's determination of the extent of antitrust immunity. *Id.* at 1321-22. The *Mishawaka* court decided that the use of primary jurisdiction was not required in the interest of obtaining the advantages of administrative expertise, stating that the agency's "expert views on what constitutes a just and reasonable rate" would in no way aid the court in determining whether a utility violated that antitrust provisions. *Id.* at 1324. Furthermore, the court rejected the argument that agency expertise was necessary to determine whether the antitrust laws are applicable to the case. *Id.*

[23]The Indiana and Michigan municipalities also sued American Electric Power Co., an investor-owned public utility holding company of which I & M is a subsidiary, and American Electric Power Service Corp., a corporation which offers management, professional, and technical services to American Electric Power Co. and its subsidiaries.

[24]*See* note 3 *supra.*

[25]Sherman Act, § 2, 15 U.S.C. § 2 (1976). Section 2 provides in part: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States shall be deemed guilty of a felony . . . ."

[26]Nos. S74-72, S75-210, S77-209, slip op. at 3.

[27]To find monopoly power, the court in *American Electric Power Co.* employed statistical share tests which gauge monopoly power based on the portion of the market the alleged monopolistic controls. Other courts which have treated price squeeze abuses have used the price squeeze as evidence of monopoly power. *See* United States v. Aluminum Co. of America, 148 F.2d 416, 437 (2d Cir. 1945); Jones, *Marketing Strategy and Government Regulation in Dual Distribution Practices*, 34 Geo. Wash. L. Rev. 456, 470 (1965).

the wholesale supply of power "on which the plaintiffs depend to serve their customers and to compete with I & M for retail sales."[28] The court observed that the plaintiffs relied on I & M for ninety-five percent or more of their wholesale power and concluded that I & M's complete control of the municipals' source of supply was by itself sufficient to find monopoly power under section 2.[29] Second, the court found that I & M had a monopoly on the retail level by defining and identifying the product and geographic components of the relevant market on that level.[30] The court stated that retail electric power obviously constituted the relevant product market.[31] Turning to the question of relevant geographic market, the court indicated that the geographic market ought to "'conform to areas of effective competition and to the realities of competitive practice.'"[32] The court concluded that the relevant geographic market in which I & M competed with the plaintiffs coincided with I & M's service area.[33]

In an effort to gauge I & M's power in the relevant market on the retail level, the district court relied on two different statistical tests.[34] The court first applied the test used in *Otter Tail Power Co. v. United States*[35] which analyzes market power by counting the number of municipalities and townships within the service area served by a large utility.[36] The court found that eighty-nine percent

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[28]Nos. S74-72, S75-210, S77-209, slip op. at 4.

[29]*Id.*, slip op. at 6.

[30]*Id.*, slip op. at 4-5; *see* United States v. Grinnell Corp., 384 U.S. 563, 570-71, 575-76 (1966).

[31]Nos. S74-72, S75-210, S77-209, slip op. at 4.

[32]*Id.* (quoting L.G. Balfour Co v. FTC, 442 F.2d 1, 11 (7th Cir. 1971)).

[33]Nos. S74-72, S75-210, S77-209, slip op. The court made it clear that the plaintiffs and I & M competed in the relevant geographic market. The court stated that I & M definitely competed with each municipal plaintiff for the right to serve all of the customers presently served by the plaintiffs' municipal utilities. *Id.* , slip op. at 6; *accord*, Otter Tail Power Co. v. United States, 410 U.S. 366, 369-70 (1973). The district court in *American Electric Power Co.* explained that, if the citizens of any of the cities voted to eliminate their municipal operations, then I & M would likely gain all of the municipalities' customers. The court also indicated that "actual and potential competition exists for certain customers presently located" in plaintiffs' corporate limits. Nos. S74-72, S74-210, S77-209, slip op. at 8. The court also found that I & M and the municipal plaintiffs were competing along the peripheries of their service areas. *Id. See also* Meeks, *supra* note 10, at 94-95 (suggesting that competition between adjacent utilities along their peripheries is not desirable). The district court's determination that competition actually existed between I & M and the municipals effectively rejected I & M's contentions that they were not competing with the plaintiffs in a relevant geographic market.

[34]For criticism of these tests, *see* notes 63-66 *infra* and accompanying text.

[35]410 U.S. 366 (1973).

[36]The *Otter Tail* test has received criticism for treating towns as units of competition because large utilities may not have a monopoly over actual retail sales because

of the units received electric power at retail from I & M within its service area, while the remaining eleven percent were served by plaintiffs and other wholesale customers of I & M.[37] The court concluded that this percentage of the market was sufficient to show monopoly power. The court also applied a retail sales test[38] to measure I & M's market dominance. By finding that I & M controlled eighty-five percent of all retail sales made by public utilities and municipalities within its service area and eighty percent of all such sales if rural electric cooperatives within the relevant market were included, the court confirmed that I & M had monopoly power.[39]

The court next considered the question whether I & M had demonstrated a general intent to abuse its monopoly power. The court defined "general intent" as "'an intent to bring about the forbidden act'"[40] which impairs another firm's ability to compete. Under this approach, the courts generally assume that, if the alleged monopolist's conduct has the consequence of excluding competition or maintaining a monopoly, then the requisite intent is shown.[41]

Accordingly, the district court examined I & M's actions for evidence of exclusionary conduct.[42] The court observed that I & M had engaged in a number of exclusionary acts,[43] including exertion of

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different communities vary in size. Stanton, *The Demise of Traditional Antitrust Law Concepts*, 44 MISS. L.J. 852, 856-57 (1973). For instance, it was found in *Otter Tail* that, although a large vertically integrated utility served 91% of the communities in its relevant market, the utility only supplied 28.9% of the total retail power in that market. 410 U.S. at 383 n.1 (Stewart, J., dissenting).

[37]Nos. S74-72, S75-210, S77-209, slip op. at 5.

[38]Use of this second test indicates that the district court was aware of the criticism of the *Otter Tail* monopoly power test. *See* note 36 *supra*.

[39]Nos. S74-72, S75-210, S77-209, slip op. at 5.

[40]*Id.*, slip op. at 13 (quoting United States v. Aluminum Co. of America, 148 F.2d 416, 432 (2d Cir. 1945).

[41]*See* United States v. Aluminum Co. of America, 148 F.2d at 432 (stating that "no monopolist monopolizes unconscious of what he is doing").

[42]The defendants in *American Electric Power Co.* argued that predatory conduct was essential for establishing an illegal monopoly under § 2. Nos. S74-72, S75-210, S77-209, slip op. at 15. Briefly considered, predatory conduct is an abnormal business practice which is directed at a specific target. L. SULLIVAN, THE HANDBOOK OF THE LAW OF ANTITRUST § 43, at 111-112 (1977). The district court rejected the need to find predatory conduct. Instead, the court applied the less stringent standard of exclusionary conduct, which is defined as "conduct that does not further competition on the merits or that tends to impair the opportunities on the merits or that tends to impair the opportunities of [the alleged monopolist's] rivals to compete." Nos. S74-72, S75-210, S77-209, slip op. at 15. The court justified its use of an exclusionary conduct standard by relying on cases advancing the principle that conduct which would be a normal business practice in absence of a monopoly situation constitutes action that a monopolist should avoid because such action would impair competition. *Id.*, slip op. at 15-16.

[43]*See* note 3 *supra*.

a price squeeze. The court stated that I & M had the duty under the Federal Power Act, as construed by the Supreme Court in *Conway*, to compare its wholesale rates against its retail rates, analyze the anticompetitive impact, and avoid or justify any disparity.[44] The court stated that I & M plainly disregarded this duty:

> As the evidence clearly indicates the defendants [including I & M] made no attempt to compare their wholesale and retail rates, much less to consider the possible anticompetitive impact of that relationship and try to avoid the anticompetitive consequences or, at a minimum, justify any anticompetitive consequences that the defendants claim cannot be avoided.[45]

The court concluded that I & M's imposition of wholesale rates in excess of its retail rates was clearly an exclusionary act because it significantly hindered the municipals' efforts to compete with I & M on the retail level and to provide their citizens with a "full range of benefits,"[46] including cheap retail service, lower electric rates, reduced tax rates, and contributions to the city's operating funds to finance needed city programs and projects.[47]

Moreover, the court indicated that I & M's exclusionary practice of imposing wholesale rates that exceeded its retail rates was not "economically inevitable" and, therefore, could not be excused on the basis of authority that exclusionary acts which cannot be avoided are not violations of the antitrust laws.[48] In fact, the court generalized that the monopolist has a duty under the antitrust laws to refrain from exclusionary conduct that is not inevitable.[49] The court stated that this legal duty under the antitrust laws is complemented by the defendant's obligation under *Conway* to consider and avoid disparities between rates actually in effect.[50] Citing evidence that I & M made no attempt to avoid a discriminatory dual rate structure when the firm filed wholesale rate requests, the court decided that I & M *willfully* disregarded its duties under *Conway* and the antitrust laws.[51]

In addition to finding that I & M possessed the general intent to abuse its power by virtue of its exclusionary conduct, the court

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[44]Nos. S74-72, S75-210, S77-209, slip op. at 10.

[45]*Id.*

[46]*Id.*, slip op. at 11.

[47]Nos. S74-72, S75-210, S77-209, separate findings of fact and conclusions of law at 2. The district court, in effect, recognized that the municipal plaintiffs provided economic benefits that justify their existence on the retail level of the electric power industry.

[48]*Id.*, slip op. at 18-19, 27.

[49]*Id.*, slip op. at 18-19.

[50]*Id.*, slip op. at 19.

[51]*Id.*, slip op. at 21.

stated that I & M's anticompetitive practices, including its price squeeze, would support a finding of specific intent to monopolize. The court indicated that specific intent is satisfied if an alleged monopolist acts with the knowledge that the probable consequence of his practices will injure competition.[52] Deciding that specific intent may be inferred from the nature of I & M's acts, the court stated that the dual rate price structure offers some proof of specific intent because such a structure is likely to have the "probable consequence" of impairing the municipals' ability to compete on the retail level.[53]

As a result of I & M's exclusionary acts, including its price squeeze, which evidenced not only a general intent but also a specific intent to abuse its monopoly power, the court granted the municipal plaintiffs over twelve million dollars in treble damages under the Clayton Act.[54] The damages were figured by computing the difference between I & M's wholesale and retail rates between 1976 and 1978. In addition, the court granted injunctive relief under the Clayton Act.[55] The court ordered I & M to calculate the "billing determinants" for each plaintiff when a new wholesale rate is requested and to compare the billing to each plaintiff to its retail rates actually in effect.[56] The court enjoined I & M from charging the municipalities any new wholesale rate if the wholesale billings exceed I & M's actual retail rates, unless FERC later decides that the wholesale rates are just and reasonable and not unduly discriminatory.[57] However, the court indicated that this injunctive relief would not prevent I & M from filing a new wholesale rate so long as it delayed collection of the rate until FERC determined its justness and reasonableness. The court stated that I & M also had the options of tailoring its wholesale and retail rates to avoid any

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[52]*Id.*, slip op. at 22 (citing United States v. United States Gypsum Co., 98 S. Ct. 2864 (1978)).

[53]Nos. S74-72, S75-210, S77-209, slip op. at 22-23.

[54]Clayton Act, § 4, 15 U.S.C. § 15 (1976). In awarding damages, the district court rejected defendant's argument that the municipal plaintiffs were not injured because they theoretically could "pass on" the higher wholesale costs to the cities' retail customers. Nos. S74-72, S75-210, S77-209, slip op. at 33-36. The court stated that the "pass-on" defense operates only if a firm and its owners are a group district from its customers. *Id.*, slip op. at 36. The court reasoned that the defense was not applicable because the municipal utility's owners and customers were the city's citizens and, therefore, were not separate groups. *Id.* The court concluded that "passing on" the overcharge would have the effect of reducing "the benefits provided by the utility" and increasing the possibility that community citizens might vote to discontinue their municipal utility and "sell it to the defendants." *Id.*

[55]Clayton Act, § 16, 15 U.S.C. § 26 (1976).

[56]Nos. S74-72, S75-210, S77-209, slip op. at 41.

[57]*Id.*

anticompetitive disparity or of timing its wholesale rate requests "to avoid charging any of the plaintiff municipalities more at wholesale" than at retail until its requests for increased retail rates are approved.[58]

In sum, *American Electric Power Co.* clearly demonstrates that the policies and functions of regulatory review and the antitrust laws can be coordinated to preserve competition on the retail level in the electrical power business by eliminating price squeeze consequences. The complementary relationship between a public utility's obligation under the regulatory scheme to avoid the anticompetitive consequences of a dual rate price structure and its corresponding duty under the antitrust laws to avoid exclusionary acts, including a price squeeze, demonstrates the "procompetitive purposes" of both the Federal Power Act and the Sherman Antitrust Act.[59] This synthesis in objectives between the antitrust laws and the regulatory scheme offers the municipals and cooperatives better protection from price squeezes. By providing the municipals with injunctive relief preventing I & M from charging wholesale rates that are greater than its retail rates until FERC effectively reviews the rates for their justness and anticompetitive consequences, the court has eliminated the price squeeze effects resulting from regulatory lag and pancaking.[60] Such injunctive relief will "shift the burden of excessive and exclusionary rates from the [municipalities] onto the [public utilities], where it belongs."[61]

III. The Future Use of Antitrust

Although *American Electric Power Co.* represents a well-reasoned statement regarding the application of antitrust principles to price squeeze abuses, a number of commentators in recent years have expressed a legitimate fear that the courts might apply the antitrust laws in an insensitive manner without considering the unique characteristics of the electric power industry as well as the regulatory policies of FERC.[62] A careful analysis of *American Electric Power Co.* indicates that the district court adequately considered the current realities of the electric industry and, therefore,

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[58]*Id.*

[59]*Id.*, slip op. at 40. *But see* Hale & Hale, *supra* note 10, at 58-59.

[60]*See* Nos. S74-72, S75-210, S77-209, slip op. at 39.

[61]*Id.*, slip op. at 42.

[62]*Hearings Pursuant to H.R. 12461*, *supra* note 10, pt. 2, at 1953 (memorandum of Hunton & Williams); Watson & Brunner, *Monopolization by Regulated "Monopolies": The Search for Substantive Standards*, 22 Antitrust Bull. 559 (1977); Note, *Refusals to Deal by Vertically Integrated Monopolists*, 87 Harv. L. Rev. 1720 (1974).

offers strong precedent for future price squeeze cases, provided these realities do not change.

One of the criticisms of applying traditional antitrust standards to a regulated setting is that many courts gauge monopoly power by only examining statistical data of the alleged monopolist's share of the market without determining whether the accused firm actually has the characteristics of monopoly power.[63] The chief indicators of monopoly power are the abilities to control prices or to exclude competition.[64] Rather than determining whether the alleged monopolist actually controls prices or excludes competition, courts, relying on the statistical share test, usually infer that a firm with a large majority of the market possesses the characteristics of monopoly power. Some experts contend that sole reliance on the statistical share test is not a useful test in regulated industries because the regulatory scheme prevents the private firm from controlling prices or excluding competition,[65] thereby foreclosing the inference of monopoly power from a firm's statistical dominance of a market. These commentators argue that the courts must examine whether the regulated scheme prevents an alleged monopolist from controlling prices or excluding competition.[66]

On the surface, *American Electric Power Co.* might be subject to criticism because the decision relied on the statistical share test to determine whether a utility had monpoly power on the wholesale and retail levels. Arguably, FERC's power to establish wholesale rates which eliminate the anticompetitive and discriminatory impact of a utility's rate request might preclude a firm from controlling prices or excluding competition, provided regulatory review was *meaningful* and *timely.*[67]

However, regulatory review of wholesale rates has not been timely and has rarely been meaningful.[68] The court in *American Electric Power Co.* stated: "The history of plaintiff's experience before the Federal Commission demonstrates that the relief it can offer invariably comes too little and too late."[69] Indeed, the municipalities in *American Electric Power Co.* suffered significant harm because I & M was allowed to collect new wholesale rates

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[63]Watson & Brunner, *supra* note 62, at 565-68.

[64]United States v. Grinnell Corp., 384 U.S. 563, 571 (1966) (quoting United States v. E.I. du Pont De Nemours & Co., 351 U.S. 377, 391 (1956)).

[65]Watson & Brunner, *supra* note 62, at 566.

[66]*Id.* at 566-68.

[67]*Id.* at 568.

[68]*But see* Missouri Power & Light Co., No. ER76-539 (F.E.R.C. Oct. 27, 1978) (definitive statement by the agency on procedure for consideration of price squeeze abuses).

[69]Nos. S74-72, S75-210, S77-209, slip op. at 12.

before the agency had completed its rate review. The district court observed that refund relief from unjust and unreasonable rates does little to alleviate the anticompetitive effect of a utility's wholesale rates during the period that they are collected while rate review remains pending.[70] Although the agency has the limited ability to suspend collection of the wholesale rates for five months,[71] such relief is of small aid because rate review often takes two to three years thereby allowing the large utility to charge its excessive rates for a considerable time.[72] Quite clearly, the investor-owned utility can control prices as well as discourage competition by filing requests for and collecting wholesale rates that exceed its retail rates because rate review is *not timely or meaningful.* Use of the statistical share test to infer monopoly power under these circumstances is adequate by itself.

Criticism also surrounds the application of traditional intent standards to monopoly situations in a regulated industry.[73] Traditionally, requisite monopolistic intent is inferred from conduct which allows the accused firm to acquire or maintain monopoly power. Some commentators have feared that the courts will infer willful intent from the ordinary business conduct of a regulated monopoly without determining if such conduct is acceptable and economically desirable in the regulated context.[74] For example, conduct that inhibits competition should not be automatic proof of willful intent if competition is not desirable or if such conduct is required by the firm's public obligations and need to guarantee reliable service.[75] Accordingly, commentators have urged the courts to avoid mechanical application of traditional standards of willful intent in a regulated setting.[76]

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[70]*Id.*, slip op. at 13.

[71]*See* Federal Power Act of 1935, § 205(e), 16 U.S.C. § 824d(e) (1976). A 1978 FERC decision indicated that the agency is attempting to reduce the anticompetitive effects of regulatory lag and pancaking by suspending the collection date of a rate request for five months, the maximum period that the agency can delay collection. Indiana & Mich. Elec. Co., Nos. ER78-379, ER78-380, ER78-381, ER78-382, ER78-383 (F.E.R.C. July 20, 1978).

[72]*See* City of Mishawaka v. Indiana & Mich. Elec. Power Co., 560 F.2d at 1325. Regulatory lag and pancaking may not be the only causes of future price abuses. Antitrust litigation may take several years to resolve because of crowded federal court dockets. Consequently, the small utilities may be vulnerable to price squeeze tactics while they await antitrust relief, unless the courts decide to grant preliminary or temporary injunctive relief.

[73]Watson & Brunner, *supra* note 62, at 575-79.

[74]*Id.* at 576.

[75]*Id.* at 577-79.

[76]*Id.* at 579-80. *See generally Hearings Pursuant to H.R. 12461, supra* note 10, pt. 2, at 1953-54 (memorandum of Hunton & Williams).

Careful review of *American Electric Power Co.* reveals that the district court did not carelessly apply the traditional standard of willful intent. The court firmly decided that the disparity between wholesale and retail rates was an exclusionary act that could not be justified on the grounds that the utility had some public obligation or need to impose an anticompetitive dual rate structure or that such competition was undesirable.[77] In fact, the court clearly found that competition on the retail distribution level was desirable. The court observed that the municipal utilities provided a number of benefits, including low electric rates, reduced tax rates, and vital contributions to city operating budgets.[78] The benefits provided by the small utility effectively justified the court's efforts to preserve competition on the retail level.

However, the court recognized that an exclusionary price squeeze should not be proof of an illegal monopoly if the price differential is an "economically inevitable" act.[79] Although the defendant did not justify its rate tactics, the court's recognition of the "economically inevitable" defense would allow a utility which honestly has different costs in providing services on the wholesale and retail levels to justify the discrimination between the rates and to escape monopoly charges because of the economic need to meet costs. In sum, *American Electric Power Co.* applied a willful intent standard that allows consideration of the realities of the electric power industry and offers the investor-owned utility some latitude to provide reliable and economical service.

Although the court in *American Electric Power Co.* applied the antitrust principles in a manner that did not offend the regulatory scheme, criticism of the use of antitrust laws in price squeeze cases should not be ignored. Future use of the antitrust laws should

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[77]Defendant I & M made no attempt to justify its rates on these grounds. I & M, however, did attempt to justify the discrimination on the grounds that it had also filed proposed changes in its retail rates at the same time that it filed for new wholesale rates. The utility argued that the price squeeze resulted because of the State Commission's delay in approving the retail rates which would eliminate the price squeeze caused by the wholesale rates that were being collected pending review by the federal commission. The court indicated that this argument was untenable because the retail rate requests are subject to change by the state commission and are, therefore, too intangible to be relied on by the public for removal of the price squeeze effects caused by the wholesale rates. Nos. S74-72, S75-210, S77-209, slip op. at 29.

[78]Nos. S74-72, S75-210, S77-209, findings of fact and conclusions of law at 2.

[79]A firm's argument that the exclusionary act is "economically inevitable" is commonly called the "thrust-upon" defense which allows an alleged monopolist to evade illegality by showing that its position was "thrust upon" it because of its superior business skill or because of natural market forces. *See* United States v. United Shoe Mach. Co., 110 F. Supp. 295 (D. Mass. 1953), *aff'd per curiam*, 347 U.S. 521 (1954).

accurately recognize the realities of the electric power industry and avoid mechanical principles that fail to accommodate regulatory factors.

IV. Conclusion

The price squeeze controversy demonstrates a significant effort by the courts to coordinate antitrust and regulatory functions and policies to preserve competition on the retail distribution level of the electric power industry. Although the Supreme Court in *Conway* firmly decided that the FPC (now FERC) has the responsibility to consider and prevent price squeeze tactics,[80] the agency's limited power to suspend the collection of rates still leaves cities and cooperatives vulnerable to the price squeeze effects of regulatory lag and pancaking. *American Electric Power Co.* represents an effort to overcome FERC's limitations by applying antitrust principles. In such application, however, the courts must consider the realities within the regulated electric industry and avoid the shortcomings of mechanical, per se rules that have little sensitivity for a regulatory scheme. If the federal courts carefully consider regulatory factors in approving wholesale rates, the substantive policies of the courts and FERC can be synthesized without injuring the regulatory scheme or vertically integrated utilities which act in a responsible manner.[81]

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[80] *See* notes 11-15 *supra* and accompanying text.

[81] *See generally* Meeks, *supra* note 10, at 75-76; Note, *Regulated Industries and Antitrust Laws: Substantive and Procedural Coordination*, 58 Colum. L. Rev. 673, 701 (1958).